A STUDY OF THE ADVANTAGES AND DISADVANTAGES OF LEASE CAPITALIZATION

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Stanford University, 1961

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Stanford University, 1962

A Thesis Submitted to the School of Government and Business Administration of The George Washington University in Partial Fulfillment of the Requirements for the Degree of Master of Business Administration

May, 1972

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CHAPTER I

INTRODUCTION

Since the end of World War II, leasing, as a means of acquiring the right to use an item, has become an increasingly popular alternative to owning assets. Where once pride of ownership was a highly dominant force in limiting the assets available to businesses to those that could be financed through either debt or equity capital, the popularity and presumed advantages of leasing over owning have significantly reduced this force and created a whole new method of financing. Although leasing itself is certainly not new and has its roots in antiquity,[1] the widespread availability of leasing as a means of acquiring the use of assets is a development of the postwar years.[2] Today, leasing is an entire industry itself. One commonly thinks of a lease as a short-term agreement to pay rent for the use of an asset. However, equally as common is the long-term lease, often without cancellation rights, written to cover the entire depreciable life of an asset. The aircraft

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[1]Donald C. Cook, "The Case Against Capitalizing Leases," <u>Harvard Business Review</u>, January-February, 1963, p. 146.

[2]Donald R. Gant, "Illusion in Lease Financing," <u>Harvard Business Review</u>, March-April, 1959, p. 121.

industry has been quite prominent as a participant in such long-term lease agreements. With the advent of the commercial jetliner in the late 1950's, buying the aircraft and leasing the jet engines was a common financing arrangement. As the number of airlines grew, particularly those in the commercial charter-type operations, it was common to lease the entire aircraft. Another industry which has been a prominent contributor to leasing has been that of computers, and, more recently, copying machines. Leasing, on a short-term cancellable basis has brought computer and copying services to many businesses that would not have been able to procure them if forced to purchase the machines through their capital budgets.

In this expanding market of leasing, there grew leasing companies and specialists; dummy corporations were formed to purchase assets with trust and pension funds, and in turn lease these assets to the parent company. The types of leases available and the forms that they took became as varied as the number of items which could be leased. But also with this growth came new problems--how to treat leases in financial statements, and how to account for leases in accordance with generally accepted accounting principles. Should a leased item be considered an asset of the business and be shown as such on balance sheets? Should the lease itself be considered a liability the same as long-term or short-term debt? These are questions that have been asked

with increasing frequency over the last twenty years; yet there is no single answer, no well-defined set of standards to follow. The accounting profession has made efforts to resolve the issue, but it has not fully succeeded. In an attempt to clarify Principle A-8 and Chapter 14 of Accounting Research Bulletin No. 43, which deal with disclosure of leases in financial statements, the American Institute of Certified Public Accountants (AICPA) engaged John H. Myers to conduct a study of leases and to make recommendations to the Accounting Principles Board (APB) regarding how leases should be reported in financial statements. Following completion of Myers' study, the APB issued Opinion No. 5, which had as its objective clarifying the issue so that standards would be set and that henceforth leases would be reported in a consistent manner in all lessees' financial statements. In 1966, two years later, Opinion No. 7 was issued to cover reporting of leases by lessors. Unfortunately, these two Opinions did not resolve the issue. The subject of capitalizing leases and thus showing them as liability and asset entries on balance sheets was broached, but there remains a broad area of interpretation. As reported in the Wall Street Journal:

> Depending on the terms of the agreement, accounting treatments can vary sharply, and often the same lease is reported to stockholders one way by the lessor and the opposite way by the lessee.
> . . . .
> In fact, on the same lease, a company can report

> one way to stockholders and another way to the Internal Revenue Service.[1]

On October 14, 1971, two committees of the APB met, one to study Opinion No. 5 and one to study Opinion No. 7, to decide whether a new interpretation or a new Opinion may be needed to provide a basis for consistency in financial reporting of leases. Prominent in these deliberations was the subject of capitalizing leases--when it should and when it should not be done.

Statement of the Research Question

Certainly, the question of lease capitalization is one of the most controversial items of accounting today. Whether or not more leases should be required to be capitalized is not the heart of the matter. The more basic question is that which forms the research question for this thesis:

> Should the present rules of the APB be altered to provide more specific and more stringent guidance in accounting for leases?

Subsidiary questions to the basic question are:

1. What are the present rules and the interpretations allowed?
2. What types of leases lend themselves to varying interpretations as to the manner in which they may be accounted for in financial statements?

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[1]Charles N. Stabler, "Accounting Rules for Lease Transactions May Be Tightened, Causing Woes for Firms," Wall Street Journal, October 14, 1971, p. 34.

3. What are the factors that favor capitalizing of leases?
4. What factors favor allowing the individual firm to decide the manner in which a lease will be reported on financial statements?
5. In capitalizing leases, what are the methods that may be used to do so?
6. What are the tax implications of making this decision?
7. If the present rules are changed to become more stringent, what are the resultant ramifications?

Scope of the Study

The attempt of this study is to bring together the information relating to the reporting of leases in financial statements to determine whether there is a need for further clarification or definition of the present APB rules for such reporting. If leases are reported in financial statements, such reporting is accomplished either through balance sheet items, assets and liabilities, or through explanatory or addendum footnotes. The basic research question concerns whether the reporting format to be used is currently well-defined. If the reporting is accomplished through balance sheet items, the lease is capitalized; but the lease is not capitalized if reporting is accomplished through footnotes. Thus, an important facet is the controversy over whether or

not leases should be capitalized. This controversy is examined, illustrating the pros and cons of lease capitalization, since tightening of the rules for accounting for leases presumably would require that more leases be capitalized. In covering this area, many of the factors that are considered in the lease versus buy and lease versus borrow alternatives are discussed. However, this study does not, per se, address the question of leasing versus owning; nor does it attempt to postulate which, under any particular circumstance, is preferable from either economic or other aspects. This subject is introduced only as it is related to the question of the reporting of leases.

Purpose and Utility of the Study

Financial statements of business entities are used by many different persons for greatly divergent reasons. Investors use them to evaluate the worth or future earning power of a firm. Lending institutions use them to evaluate the debt-carrying capacity of a firm interested in securing a loan. Auditors use them to determine whether, in fact, they fairly represent the firm's operations and financial position. Stockholders use them for evaluating the stewardship in which they have placed their money to determine whether their investment has been worthwhile. A firm itself uses them to determine how well it is doing in relation to the past, to similar concerns, and to the economy as a whole.

Thus, it is imperative that the rules for preparing such statements be stated in a manner that will produce a fair and complete report as well as one that is consistent with reports of other firms. The financial statement itself, in an absolute sense, has little value to a firm; it is only its use in relation to statements of other firms that gives it value. Thus, consistency is important. The AICPA has made repeated attempts to clarify lease reporting criteria, the most recent being APB Opinions: Opinion No. 5 and Opinion No. 7. However, the problem of consistent treatment by all firms continues. In March, 1965, shortly after Opinion No. 5 was issued, it was hypothesized that: "It is likely that Opinion No. 5 will not significantly change the way leases are now reported and might well serve to confuse rather than to clarify the problem."[1] In November, 1970, David F. Hawkins, in discussing possible ramifications of revising these two Opinions, listed the following as two improvements which had been suggested:

> Expand the disclosure requirements and be more specific in stating what must be disclosed.
> Provide more specific rules to help practitioners interpret the capitalization recommendations of Opinion No. 5.[2]

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[1]Willard J. Graham and Harold Q. Langenderfer, "Reporting of Leases: Comment on APB Opinion No. 5," Journal of Accountancy, CXIX (March, 1965), 59.

[2]David F. Hawkins, "Objectives, Not Rules, for Lease Accounting," Financial Executive, XXXVIII (November, 1970), 34.

In October, 1971, Charles N. Stabler reported in the Wall Street Journal: "The trouble is that the two rules, which date to 1964 and 1966 respectively, are inconsistently interpreted in some areas and need clarification."[1]

The need to revise these Opinions is well recognized. How to revise them, if in fact they are to be revised, is the purpose of two studies currently being undertaken by committees of the APB. The purpose of this thesis is to identify the current situation and present the opposing arguments for the way disclosure should be handled--the cases for and against capitalizing leases. The utility of the study lies in the existence of a single document that presents both viewpoints, from which the reader can take his stance in the controversy.

Research Methods Utilized

First, to provide a basis for research, various documents sponsored by the AICPA relating to lease accounting were obtained and reviewed. Among the sources consulted were the February, 1971, publication, APB Accounting Principles; Chapter 14 of Accounting Research Bulletin No. 43, "Disclosure of Long-Term Leases in Financial Statements of Lessees"; Accounting Research Study No. 4, Reporting of Leases in Financial Statements; APB Opinion No. 5, Reporting of Leases in Financial Statements of Lessees; and APB Opinion

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[1]Stabler, "Accounting Rules May Be Tightened," p. 34.

No. 7, Accounting for Leases in Financial Statements of Lessors.

Subsequently, articles in periodicals relating to leases and lease accounting were sought through the Readers' Guide to Periodical Literature, Business Periodicals Index, and Accountants' Index Supplement. Many of the articles themselves provided additional references on the subject matter. Also utilized were various books and textbooks dealing with leases and accounting.

Organization of the Study

Chapter I is the introduction to the subject, posing the research questions. Also included is an explanation of the purpose and utility of the study.

An historical background of lease accounting procedures as defined by the AICPA through the APB is the main thrust of Chapter II. This background illustrates what changes have taken place and defines what present accounting rules require. Also, the recent rise in the use of leases is discussed, and the current lease capitalization controversy is introduced.

Chapter III discusses types of leases differentiating between operating and financial leases. Defined is the type of lease involved in the capitalization controversy. The second part of this chapter presents the case for lease capitalization. The opposite side, the case against capitalization is given in Chapter IV.

One argument against requiring leases to be capitalized is that agreement has not been reached on how it should be done from a procedural standpoint. Chapter V presents the alternative methods and a discussion of the merits and faults of each method. Also included in this chapter is a discussion of the tax effects of leases and how the taxable income of a firm can vary substantially depending upon how the lease is written and whether or not it is capitalized on the balance sheet. A third alternative presented is accounting for leases one way for financial statement purposes and another way for tax purposes.

Chapter VI is the concluding chapter, which presents the effect of lease capitalization beyond the accounting question and the results of the study pertaining to the research question. To aid the reader's continuity of thought, summaries are presented at the end of each chapter.

CHAPTER II

HISTORICAL BACKGROUND

Recognition of Leases by the AICPA

Although the recognition of a lease as a business transaction has long been acknowledged by the American public, official recognition in any detail was not made by the accounting profession until 1949. John H. Myers, in a research study sponsored by the AICPA, states that this recognition came about as a result of the increasing use of the lease as a financing device. He reasons that traditionally the accounting treatment for leases was to recognize rental payments only when due or as accrued, showing no balance sheet liability; thus, the use of the lease conformed to the rule of thumb that the lower the liabilities the better the financial condition of the company.[1]

The History of Leases in Law

Donald C. Cook has summarized in an article in the *Harvard Business Review* the development of the lease from a legal standpoint.[2] In relation to real property, he traces

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[1] John H. Myers, *Reporting of Leases in Financial Statements*, Accounting Research Study No. 4 (New York: American Institute of Certified Public Accountants, 1962), p. 1.

[2] Cook, "Against Capitalizing Leases," pp. 146-49.

the lease to Roman law through early English law. In Roman law the lease was a contractual right to the use of property without ownership accruing to the lessee. From 1200 to 1500 there was a change in that the lease was considered more a conveyance than a contractual agreement of use, and the lessee was recognized as having gained an interest or equity in the land. It is this point in history, he contends, that is used as the basis for any claim that a lease should be regarded as an asset and shown as a balance sheet item. The connection comes from the premise that unless some equity is gained in the property being leased, there is no reason or basis upon which to capitalize the lease, showing it as an asset and a liability. However, if equity is built up in the leasing process, then there is justification for requiring the lease to be capitalized. He categorizes United States law today as a "synthesis of conveyance notions and contract notions," meaning that decisions in law used as precedents have interpreted leases in two ways: (1) contracts giving only rights of use; and, conversely, (2) the conveyance or transfer of title to the property to the lessee. The result is that a lease is not necessarily always one or always the other, but, depending upon the interpretation of the terms of the lease, it could be judged either way. The effect is that there is no singular definition of a lease.[1]

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[1] Ibid., p. 147.

Cook relates the law of leases of personal property to the law of bailments, as distinguished from the law of landlord and tenant which relates to leases of real property. In the history of the law of bailments, the relationship between bailor (lessor) and bailee (lessee) has remained contractual and has not been subject to the duality of contract and conveyance as in law regarding real property. It is this basis in law that Cook uses as a primary justification to support the contention that a lease is not a conveyance but an executory contract and, thus, should not be treated as a balance sheet item reflecting an asset and a related liability. It is upon this controversy over whether a lease is a conveyance or executory contract that much of the argument for and against capitalizing leases is based.

Treatment of Leases by the AICPA

Accounting Research Bulletins No. 38 and No. 43

In 1949, the accounting profession began to deal in substance with the treatment of leases in financial statements through issuance of Accounting Research Bulletin No. 38, prepared by a committee of the AICPA. The essence of the problem stated in this bulletin is quoted below:

> 1. The growth in recent years of the practice of using long-term leases as a method of financing has created problems of disclosure in financial statements . . . .
>
> . . . .
>
> 3. It has not been the usual practice for companies renting property to disclose in financial

> statements either the existence of leases or the annual rentals thereunder. One of the effects of the long-term lease as a substitute for ownership and mortgage borrowing is that neither the asset nor any indebtedness in connection with it is shown on the balance sheet. . . .[1]

The opinion expressed by the committee in response to this problem was:

> (a) disclosure should be made in financial statements or in notes thereto of:
>
> (1) the amounts of annual rentals to be paid under such leases with some indication of the periods for which they are payable, and
>
> (2) any other important obligation assumed . . . ;
>
> (b) the above information should be given not only in the year in which the transaction originates, but also as long thereafter as the amounts involved are material; and
>
> (c) in addition, in the year in which the transaction originates, there should be disclosure of the principal details of any important sale-and-lease transaction.[2]

The committee also stated:

> . . . where it is clearly evident that the transaction involved is in substance a purchase, then the "leased" property should be included among the assets of the lessee with suitable accounting for the corresponding liabilities and for the related charges in the income statement.[3]

This initial guidance provided to accountants began the continuing debate over how leases should be treated in financial statements. Although meant to be an answer to the growing question, this bulletin merely provided general guidance which was left open to wide interpretation. In

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[1] Myers, Reporting of Leases, p. 2.

[2] Ibid. [3] Ibid.

effect, all that was required was some type of disclosure statement except when the lease amounted to a purchase. Then, capitalization was required. However, there was no real definition of what lease terms would constitute a purchase. In 1953, Accounting Research Bulletin No. 43 was issued to restate, in an updated manner, all previously issued bulletins, numbering 1 through 42. Bulletin No. 38 was reissued in nearly identical wording and appeared as Chapter 14 of Accounting Research Bulletin No. 43.

Accounting Research Study No. 4

In 1962, Maurice Moonitz, director of accounting research of the AICPA, engaged John H. Myers, then professor of accounting at Northwestern University, to conduct a study of leases and recommend a set of accounting principles for use in insuring adequate disclosure of leases in financial reports.

Myers saw the problem as determining whether any, and if so what, changes were needed in accounting procedures in order to present full and fair disclosure of leases in financial reports. He resolved the problem into two questions: "(1) What information should be given? (2) Should the property rights under lease and the obligation therefor be shown on the balance sheet?"[1] In formulating this study, he made the following observations:

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[1] Ibid., p. 3.

1. Leasing has grown in importance and in multiplicity of forms.
2. Disclosure in notes to the financial statements has become a matter of course on a basis equal to or, in a great many cases, less than the minimum recommended in the Bulletin [ARB No. 38].
3. The financial analysts have sought more information than is recommended in the Bulletin.
4. The balance-sheet presentation of leases which were "in substance a purchase" has been almost non-existent.[1]

Thus, from the standpoint of the lessee, Myers' primary conclusion was that more information regarding leases was needed by disclosure in financial statements in order that analysts and users of these statements could properly determine the extent of obligation comparable to the manner in which debt obligation is determined. Although this information could be shown either by footnotes to the balance sheet or by incorporation into the balance sheet itself, Myers strongly recommended that, to the extent a lease gives rise to property rights, the information should be placed directly on the balance sheet, and not as notes thereto.[2] The type of lease in which the entire payment constitutes the gaining of property rights has substantially the following provisions:

1. Length--The lease covers substantially the entire useful life of the leased property.
2. Option at termination--The lessee may buy the property at the termination of the lease for a nominal price.
3. Cancellation provisions--The contract is non-cancellable.
4. Rent--The lessee pays fixed amounts (as distinguished from variable) sufficient to return to the lessor his investment in the property under lease plus a fair return.

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[1] Ibid. [2] Ibid., p. 4.

5. Taxes, insurance, maintenance--These and other similar costs are to be paid by the lessee.[1]

In types of leases with provisions other than the above, according to Myers, only a portion of the rental payment is for property rights. His contention is that whatever portion of the lease payment is payment for property rights is that portion which should be recognized as the acquisition of an asset and the incurrence of a liability. It is this asset and liability which should be capitalized.[2]

In discussing the method by which a lessor accounts for lease payments, Myers presents two possible choices of methods, the terms of the lease dictating the more appropriate one to use. The first is the "rental" method, by which the rental receipt is recognized as revenue for the period. This method should be used for that portion of rental covering services to be performed by the lessor or for the entire rental payment when no property rights pass on to the lessee, as in daily or monthly leases. The second is the "finance" method, which involves an accounting procedure similar to that used for credit sales, by which a receivable account is set up and an asset account for the item is credited for the item "sold." By this method, the rental receipts are divided between repayment of principal and finance charges. This method would be used for leases under which the lessee does obtain property rights.[3]

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[1]*Ibid.* [2]*Ibid.*, p. 5. [3]*Ibid.*, p. 9.

In summary, from the standpoint of both the lessee and the lessor, when the transfer of property rights occurs in a lease transaction, the lessee should capitalize the lease on his balance sheet and the lessor should move the asset from the "fixed asset" category to the "receivable" category of his balance sheet.[1]

Opinion No. 5

Following completion and publication of Myers' study, the APB considered his recommendations and his study in issuing Opinion No. 5. The APB, however, did not wholly concur with his recommendations, and instead stated that "the distinction [of whether an asset and liability should be created on the balance sheet of the lessee] depends on the issue of whether or not the lease is in substance a purchase of the property rather than on the issue of whether or not a property right exists."[2] The purpose of Opinion No. 5 was to extend and clarify Chapter 14 of Accounting Research Bulletin No. 43, regarding the requirements for disclosure and the criteria for determining when leases are in effect purchases.

The following are pertinent items as quoted from Opinion No. 5:

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[1]Ibid., p. 64.

[2]Accounting Principles Board, Opinion No. 5: Reporting of Leases in Financial Statements of Lessee (New York: American Institute of Certified Public Accountants, September, 1964), para. 5. Cited hereafter as Opinion No. 5.

> Leases covering merely the right to use property . . . do not create an equity in the property and are thus nothing more than executory contracts requiring continuing performance on the part of both the lessor and the lessee . . . .[1]

> The rights and obligations under leases which convey merely the right to use property, without an equity in the property accruing to the lessee, fall into the category of pertinent information which should be disclosed in schedules or notes rather than by recording assets and liabilities in the financial statements.[2]

> The property and the related obligation should be included as an asset and a liability in the balance sheet if the terms of the lease result in the creation of a material equity in the property. . . . The presence, in a noncancellable lease or in a lease cancellable only upon the occurrence of some remote contingency, of either of the two following conditions will usually establish that a lease should be considered to be in substance a purchase:
>
> a. The initial term is materially less than the useful life of the property, and the lessee has the option to renew the lease for the remaining useful life of the property at substantially less than the fair rental value; or
>
> b. The lessee has the right . . . to acquire the property at a price which at the inception of the lease appears to be substantially less than the probable fair value of the property at the time or times of permitted acquisition by the lessee.[3]

> Unless it is clear that no material equity in the property will result from the lease, the existence, in connection with a noncancellable lease or a lease cancellable only upon the occurrence of some remote contingency, of one or more circumstances such as those shown below tend to indicate that the lease arrangement is in substance a purchase and should be accounted for as such.
>
> a. The property was acquired by the lessor to meet the special needs of the lessee and will probably

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[1] Ibid., para. 7.

[2] Ibid., para. 10.

[3] Ibid., para. 11.

be useable only for that purpose and only by the lessee.

b. The term of the lease corresponds substantially to the estimated useful life of the property, and the lessee is obligated to pay costs such as taxes, insurance, and maintenance, which are usually considered incidental to ownership.

c. The lessee has guaranteed the obligations of the lessor with respect to the property leased.

d. The lessee has treated the lease as a purchase for tax purposes.[1]

In specifying what disclosure is required when leases are not capitalized but shown only through balance sheet footnotes, Opinion No. 5 states:

> The financial statements or the accompanying notes should disclose the minimum annual rentals under such leases and the period over which the outlays will be made.[2]
>
> Rentals for the current year . . . should be disclosed if they differ significantly from the minimum rentals under the leases. Type or types of property leased, obligations assumed or guarantees made, and significant provisions of lease agreements (such as restrictions on dividends, debt, or further leasing or unusual options) are examples of other types of information which should also be disclosed.[3]

Opinion No. 7

Less than two years later, in May, 1966, the APB issued Opinion No. 7, which dealt with accounting for leases by lessors. The essence of Opinion No. 7 was to describe two methods for allocating rental revenue and the situation under which each should be used. These methods are called

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[1] Ibid.

[2] Ibid., para. 16.

[3] Ibid., para. 17.

the "financing" and the "operating"[1] methods. Under the financing method, rental is divided into interest and recovery of investment or principal. Only the interest portion is considered to be revenue. Under the operating method, the entire rental amount is considered to be revenue, and the expenses associated with this revenue are depreciation, maintenance costs, and any other service costs under the lease arrangement.

According to Opinion No. 7, the financing method is appropriate for "entities engaged in, perhaps among other things, lending money at interest--e.g., lease-finance companies, banks, insurance companies or pension funds." The basic implication is that leases written by these types of institutions place the risk and reward of ownership on the lessee and the lessor expects total recovery of his investment as well as appropriate return on this investment.[2]

Where the usual risks of ownership reside with the lessor, the operating method is deemed more appropriate. Examples given in Opinion No. 7 are the owner-operator of a building and an equipment lessor utilizing short-term leases--daily, weekly, or monthly.[3]

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[1] Cf. "rental" method as presented by Myers, *supra*, p. 11.

[2] Accounting Principles Board, *Opinion No. 7: Accounting for Leases in Financial Statements of Lessors* (New York: American Institute of Certified Public Accountants, May, 1966), para. 8. Cited hereafter as *Opinion No. 7*.

[3] *Ibid.*, para. 9.

Overall, it is the character of the leasing agreement which determines the current method of accounting for lease rental payments. A financing institution could use the operating method if its lease were written as such, and non-financing institutions could use the financing method if their lease were of that type. A single firm could use both methods if it had leases in each of these two categories.

Paragraph 18 of Opinion No. 7 discusses a possible interpretation of inconsistency with Opinion No. 5 in that if a lessor uses the financing method, must the lessee capitalize the lease? The Board states that although the financing method may be the proper way to fairly state the lessor's income, it does not automatically follow that capitalizing the lease by the lessee is the proper way to fairly state net income, "since the amount of the lease rentals may represent a proper charge to income."[1] This could apply only when the lease is not, in fact, a purchase.

Comment on Opinion No. 5

The last paragraph of Opinion No. 7 sets the tone for the current status of the accounting treatment of leases as it boldly states: "There continues to be a question as to whether assets and the related obligations should be reflected in the balance sheet for leases other than those that are in substance installment purchases."[2] Opinion No. 5

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[1] *Ibid.*, para. 18. [2] *Ibid.*

and *Opinion No. 7* are the last official position statements of the AICPA. Since their issue the controversy over lease capitalization has raged on, each side using those interpretations of the opinions most closely fitting their end desires. A key objective of *Opinion No. 5* was to provide requirements for more complete disclosure of leases, but, according to David Hawkins, this objective was not met. He states: "The *Opinion* set some minimum disclosure requirements, but left it up to management and the auditors to select the method and details of disclosure that best reflected the circumstances."[1]

In 1965, the reflections of a seminar regarding *Opinion No. 5* were reported in the *Journal of Accountancy*:

> It seems that the Board is trying to emphasize artificial differences between leases which are purchases and those which are "true" leases, rather than concentrate on similarities which arise when the substance of a transaction gives rise essentially to all of the rights and obligations of ownership. In the process of emphasizing differences, the Board has implied that the form of the transaction is more important than its substance.[2]
>
> Its [*Opinion No. 5*] fundamental weakness is in its inadequate definition of the characteristics of a lease that make it an asset, a definition which is artificially narrow in scope and seemingly too dependent upon rules created within the framework of different institutional objectives.[3]

The AICPA and the APB have recognized the problem of inconsistent interpretation of these opinions and have set

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[1]Hawkins, "Objectives, Not Rules," p. 31.

[2]Graham, "Comment on Opinion No. 5," p. 59.

[3]*Ibid.*, n. 4, p. 59.

out to rectify the situation. The two committees, mentioned eariler, are currently in session attempting to produce the answer to the question of "correct" interpretation of previous APB statements and elimination of the current inconsistencies of reporting. The overall objective seems now to be to publish a set of rules which are not open to wide interpretation, but are specific in detail so that any given type of lease will be reported in the same manner and in the same degree of detail by all firms.

Summary and Conclusions

Lease accounting has been the subject of a great amount of debate since World War II. Although the AICPA has issued various rules and positions on the subject, there is still no consistent interpretation for the accounting of all types of leases in financial statements. There are essentially two areas of controversy. The first is in regard to how fully or in what detail the particulars of a lease should be disclosed in financial statements. The second, the area subject to the more intense debate, is whether certain leases should be capitalized on balance sheets rather than being carried as off-balance-sheet items, with rental shown only as a current expense of the period and no liability shown for future rental commitments. The resolution of the controversy should provide the most objective way of fairly showing the financial position of the firm. This would be the requirement

that all noncancellable future lease commitments be shown as liabilities. But resolution is not that simple. The next chapters will examine the various factors involved and the cases for and against lease capitalization. The problem of disclosure seems to be the more easily resolvable. If a lease is capitalized, there is full disclosure of the firm's liability and its total assets in use. Even those opposing capitalization of leases agree that footnote disclosure should spell out the details of the lease so that it could be capitalized by an analyst if he so desired.

Leasing of assets has grown to become a major industry in the United States. How much of this growth is due to the vagaries of accounting treatment is not known, but, certainly, accounting treatment has been a factor. The future of leasing as a popular form of financing may well be dependent upon changes in accounting rules in the years ahead. But, whatever the future effect on leasing, the accounting profession must look at leasing and its accounting treatment with an objective eye, keeping in mind that the result should be geared solely to fair reporting of the position of the firm, and examine the substance and intent of the transaction to determine the proper way of accounting for it and reporting it in financial statements.

CHAPTER III

THE CASE FOR LEASE CAPITALIZATION

Types of Leases

Leases may be categorized in different ways and by different terms. They may be short-term or long-term, cancellable or noncancellable, and operating or financial. The primary distinction of concern to this report is that between operating and financial leases, which implicitly include short-term versus long-term leases, as well as whether or not the lease is cancellable. Further, the discussion will be limited primarily to financial leases, since this report deals with the controversy over the accounting treatment of leases and there is little controversy over the accounting treatment of an operating lease.

Richard F. Vancil distinguishes between financial and operating leases by the type of commitment the lessee assumes. A financial lease is one in which the total payments exceed the cost of the item leased, the payment period is approximately equal to the economic life of the item, and the lease is noncancellable. Basically, this type of lease is a means of acquiring the use of an item without purchasing it, and inherent in the lease is the surrendering of any residual value at the termination date. The lessee

is committed to providing the lessor with full recovery of his investment in the property. An operating lease is any other type of lease; the primary distinguishing characteristic is its cancellability upon due notice. The operating lease does not involve any fixed future commitment or risk of ownership as does the financial lease.[1]

As discussed in Chapter II, Myers classifies leases on the basis of whether property rights to the item are gained by the lessee through the making of rental payments. He states that these property rights are gained if, in addition to the features of the financial lease, the lessee has an option to buy the item at the termination of the lease; the rent is a fixed amount; and taxes, maintenance, and insurance are paid by the lessee. It is for this type of lease that he makes his case for capitalization of the full lease payment. For other types of leases, that portion of the rental which does not entail property rights is disclosed through footnotes to the balance sheet.[2] Thus, in general, operating leases would not be subject to capitalization. Opinion No. 5 limits consideration of lease capitalization to noncancellable leases, or, in Vancil's terminology, to financial leases.[3]

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[1]Richard F. Vancil, Leasing of Industrial Equipment (New York: McGraw-Hill Book Company, Inc., 1963), pp. 8-9.

[2]Myers, Reporting of Leases, pp. 4-5.

[3]Opinion No. 5, para. 10-11.

Donald R. Gant has described a financial lease as one in which rental payments need not be level so long as they return to the lessor his investment plus some rate of return, and the rental payment may be such that it covers maintenance, taxes, insurance, and other expenses in addition to this investment recovery and rate of return.[1]

Again referring to Chapter II, accounting rules of the APB distinguish between types of leases on the basis of how financial statement disclosure should be handled. This distinction is founded on material equity gained in the leased property and whether or not it is, in fact, a purchase. In Opinion No. 5, Myers' differentiation of leases, based on the grounds of attainment of property rights, was rejected in favor of a distinction based upon the fact of whether or not the lease created for the lessee material equity in the property. This was considered the determining factor for whether or not a lease was a purchase, and only those leases judged to be purchases were required to be capitalized.[2]

Thus, it is seen that classification of leases has not been given consistent treatment, and the definition of classification depends upon what view one is supporting. The only points of common agreement in regard to capitalization are that operating leases do not generally fall into

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[1]Gant, "Illusion," p. 123.

[2]Henry G. Hamel, Leasing in Industry, Studies in Business Policy, No. 127 (New York: National Industrial Conference Board, 1968), p. 69.

the realm of capitalization potential because of their cancellability and that financial leases that are in effect purchases should be capitalized. As will be shown later, a major consideration in leasing versus purchasing is the tax advantage of leasing. Tax laws relative to defining which leases are in reality purchases are an overriding factor in drawing up a lease so as to avoid its being termed a purchase and thus rejected as a lease by the Internal Revenue Service. The area of controversy is that concerning financial leases that do not have the features for classification as purchases. The remainder of this chapter and Chapter IV will present the arguments that have been advanced both for and against capitalization of these leases. Inherent in any such evaluation is the discussion of some of those factors that favor leasing over buying or borrowing, since capitalization can affect the validity or strength of these factors.

Factors Favoring Capitalization

Reporting of leases

Once leasing has been decided upon as the means of financing a particular item, the method of reporting the lease in financial statements must be determined. This method could be not reporting the least at all, except by showing the rental accrued during the period as an expense; reporting the lease in a footnote to the balance sheet; or showing the leased item as an asset and the obligation of

future rental payments as a liability. The method chosen will depend upon the lease itself as well as the philosophy of the enterprise. The choice of reporting method is a major factor underlying the capitalization question. In 1960, Maurice Moonitz stated that a great deal of debt was being omitted from financial statements of firms that leased properties, because accountants were not showing leases in statements of financial position. His contention is that lease payments are definitely liabilities, and future lease obligations should be shown as such.[1] John Hennessy presents the same opinion by stating that footnote disclosure is an inadequate method of lease accounting, and that an asset and a liability should be shown in financial statements. He further points out that the accounting method is optional and that:

> As long as an alternative treatment is permissive, most companies will de-emphasize such obligations by omitting them [leases] from the financial statements proper and confine disclosure to the footnotes. As generally happens in such circumstances, the minimum reporting requirements set the standard.[2]

Although these statements were made when Accounting Research Bulletin No. 43 was the AICPA guideline, many of the same alternatives are still available under Opinion No. 5, the current set of rules. Therefore, not only is the call

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[1]Maurice Moonitz, "The Changing Concept of Liabilities," Journal of Accountancy, CIX (May, 1960), 45.

[2]John L. Hennessy, "Recording of Lease Obligations and Related Property Rights," Journal of Accountancy, CXI (March, 1961), 45.

for requiring more leases to be capitalized a strong one, but equally as strong is the call for eliminating alternatives for the method of disclosure. Requiring capitalization would eliminate alternatives and make standardized reporting practices a necessity.

Leases as equivalent to debt

The primary justification for capitalizing long-term noncancellable leases is the concept of fair reporting of the financial situation of a firm. Proponents view such leases as equivalent to debt, which should be so reflected on the balance sheet. This concept leads to the first area of investigation, that of determining what a lease is. It has been advanced that where the lessee has a noncancellable obligation to pay rent for rights to use property, he has, for the term of the lease, the same obligation and rights of use as an owher that incurs debt to purchase the same property, even though the type of transaction is different. The only distinction between the two comes at the end of the lease, when the obligation of the lessee has expired. The owner has title to the residual value of the item; the lessee does not. At most, the lessee has only the option to purchase the item; he does not have title to it.[1] To further the contention that obligations under a lease are comparable to debt obligations, it has been offered that lease payments are

[1]Graham, "Comment on Opinion No. 5," p. 59.

fixed obligations which, when due, are legally enforceable claims that are not junior to debt claims. Opponents of this view state that under bankruptcy or reorganization the maximum claim would be limited to one and three years rent, respectively, whereas a mortgage lender is entitled to the full difference between the realizable value of the property and the outstanding balance of the loan.[1] Thus, the conclusion is that a lease is not equivalent to debt. The counter argument is that this view presumes future insolvency rather than the going-concern principle of accounting. Further, in the event of reorganization, it could well be that the leased asset is vital to the continued operation of the business, and, thus, the rental obligations could take a position senior to debt, which would remain in default.[2]

Leonard Spacek views the practice of not recording leases as balance sheet items a result of historical precedent. In earlier times, when leases were relatively unimportant, it became accepted practice not to record them, and this tendency has continued in the instance that lease obligations are significant.[3] Another view, favoring leases as debt equivalents, is that "investors in a lease financing transaction look more to the general credit of the company

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[1]Donald R. Gant, "A Critical Look at Lease Financing," Controller, XXIX (June, 1961), 274.

[2]Ibid.

[3]Leonard Spacek, "Can We Define Generally Accepted Accounting Principles?" Journal of Accountancy, CVI (December, 1958), 46.

for this investment security than to the value of the property involved."[1] As support for this statement, Gant refers to such investors as banks, insurance companies, and pension funds which involve themselves in low-risk investments. They will not insure mortgage loans for the full value of property, but will provide 100 per cent financing under a lease. Gant contends that they do this because they consider the lessee has assumed the risk of ownership and the entire transaction is based on the credit of the lessee, not the value of the leased asset to the investor. He offers the fact that, for leasing operations, the credit analysts use the standards demanded for a bond indenture for direct debt, which are based on the credit worthiness of the firm, rather than mortgage loan standards, which are based on the value of the property.[2] In this instance, leases appear to be nearly identical to debt.

The results of the above arguments are that if a lease is equivalent to debt, then it should be reported as such on the balance sheet, not as a footnote. If a lease is carried on the balance sheet as a capitalized item, it is shown as an asset reflecting the right to use the property, and as a liability which is the present value of the rental payments. Chapter V discusses the details of the various methods which could be employed for arriving at the value of this liability and asset.

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[1]Gant, "Illusion," p.123. [2]*Ibid.*, pp. 123-24.

Asset and liability
aspects of leases

A second area of controversy is whether or not a lease represents an asset or a liability. Summarizing from Chapter II,[1] Opinion No. 5 states that except where the lease is, in effect, a purchase, and a material equity is created in the property, no asset and liability are created. For material equity to be created, the lease must be for a term materially less than the useful life of the property, and the lessee must have an option either to purchase the property at the end of the lease for less than fair market price or to continue to lease at rates less than fair rental value. The criteria for a purchase are such circumstances as: the property was acquired to meet special lessee needs; the terms of the lease correspond to the life of the asset, and the lessee pays all maintenance, taxes, and insurance costs; the lessee guarantees the lessor's obligations for the property; or the lessee treats the lease as a purchase for tax purposes. Otherwise, the lease is regarded as an executory contract, no asset or liability is created, and rights and obligations are recorded only through footnotes or schedules. It is clearly stated in Opinion No. 5 that the right to use property creates neither asset nor liability.

The position of Opinion No. 5 can be challenged from either the asset or liability side of the question.

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[1]Supra, pp. 19-20, Opinion No. 5, para. 7-11.

Opinion No. 5 states that assets exist only if material equity is created. Assets can be intangible; therefore, owning the right to use something is owning something intangible without having legal title to it. The asset created is the right to use the item. Assets may be acquired through incurrence of liabilities; yet the rapidity of liquidating that liability should have no bearing on whether the asset exists. The position of the Board that existence of an asset occurs only where legal title exists, and that the timing of the payment of the obligation is a criterion of whether an asset exists, is challenged as invalid.[1] Although a lease provides basically the same rights and obligations as ownership, the Board treats the two situations differently, implying that "the form of the transaction is more important than its substance."[2] Whether under ownership or through non-cancellable lease, a firm has the right to use the property as well as the obligation to pay for it, either as loan repayment or rental payments. It has been proffered that irrevocatility is the key criterion for determining whether an asset has been created through execution of a lease.[3] Myers, in Accounting Research Study No. 4, concurs that property rights do give rise to the creation of an asset; however, his opinion was overruled by the Board in issuing Opinion No. 5, which was based on his study.

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[1] Graham, "Comment on Opinion No. 5," p. 58.

[2] Ibid., p. 59.

Looking now at the liability side of a lease, the question turns on whether a financing arrangement creates a liability. In comparing a lease with a cash loan, if they are the same as to the liability created, then the accounting treatment should be the same. In each case an item is acquired, cash in one case and use of an asset in the other; and payment to the lender for the use of the item as well as repayment of the item itself is scheduled over a period of time. For the lease, the same asset is returned at the end of the lease, although sometimes this, too, becomes a payment of cash to the lender. Other than this, the two transactions are the same; thus, their accounting treatment should be the same. For the cash loan, the cash received is recorded as an asset, and a liability is established in the amount of the loan. To treat the lease similarly, the liability would be the lease payments and the asset would be the right to use the property.[1]

Although Opinion No. 5 denies the existence of an asset or a liability in a lease where only property rights are attained, and where no material equity exists, a strong case can be supported for countering this position by looking at the lease as an asset or as a liability, and, in reality, it is both. The extension of this thought is capitalizing the lease to show the asset and related liability on the balance sheet.

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[1]Ronald J. Huefner, "A Debt Approach to Lease Accounting," Financial Executive, XXXVIII (March, 1970), 30-31.

<u>The lease as an executory contract</u>

<u>Opinion No. 5</u> classifies leases as executory contracts, that is, a contract wherein there is a requirement for continuing performance on the part of both the lessee and the lessor. In accordance with generally accepted accounting principles, executory contracts are required to be disclosed, with respect to rights and obligations, in notes to financial statements or in separate schedules. This treatment is specified rather than capitalization by recording them as assets and liabilities.[1] The question arises whether a lease is an executory contract--whether or not there are equally unperformed services remaining in a lease. The argument against leases being considered executory contracts interprets the lessor's part of the agreement as executed upon turning the property over the lessee. The only future act required of him is to honor the agreement to leave the property at the disposal of the lessee for as long as the rental payments are made. This act on the part of the lessor is not considered "continuing performance." If there is no continuing performance required of each party, an executory contract does not exist, and, if the lease is not an executory contract, capitalization is a proper method of recording it.[2] Maintenance or other services provided

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[1]<u>Opinion No. 5</u>, para. 8.

[2]Huefner, "Debt Approach," p. 31.

by the lessee do constitute unperformed services for future periods, and the portion of the lease covering these items should not be capitalized.[1]

The lease and its effect on ratios

One of the primary uses of financial statements is for conducting a financial analysis of a firm. Primary in this analysis is the calculation of various ratios for comparison either with other firms or with industry standards and averages. A strong case can be developed to support lease capitalization by comparing two identical firms; one leases significant assets and the other purchases them through incurring debt. Although a ratio analysis should show that the two are equivalent, it will be shown here that this analysis reflects greatly different financial positions. Ratio analysis, it is granted, is not the sole determinant of financial position, but a tool commonly used in evaluating a company; thus, ratios are important. If failure to capitalize a lease results in distortion of these ratios to a significant degree, then the case for capitalization is enhanced.

An example.--A hypothetical example has been constructed to show the effect on ratio analysis of alternative ways of financing the acquisition of an asset and of alternative ways of reporting the lease transaction.

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[1] Ibid.

Table 1 shows the balance sheet and income statement of the firm before the acquisition of the asset. In Case A (see Table 2) an asset is purchased with funds obtained on a 5 per cent loan. The life of the asset is ten years, and straight-line depreciation is used. For the first year the interest payment is $100. In Case B (see Table 3), the asset is leased for ten years at a cost of $300 per year. The rental is an expense charged to cost of manufacturing. No mention of the lease is made in the balance sheet except for a footnote stating the annual charge. It is not shown as an accrued expense; the payment is made from current assets just prior to the close of the period. In Case C (see Table 4) the same lease is negotiated, but it is capitalized and shown on the balance sheet. Considering that the asset could be purchased for $2,000, this figure is used as the initial asset and liability amount. Using present value tables, it can be seen that the rental of $300 per year for ten years for an asset with a present cost of $2,000 represents an interest rate of 8 per cent. The asset, the right to use the item, is depreciated straight line, or $200 per year. The liability is amortized by the balance of the lease payment after deducting the implied interest of 8 per cent on the liability balance. In the first year, the interest is $160 (8 per cent of $2,000); thus, the residual from the $300 rental payment, $140, is the amount of the liability which is amortized. This is essentially the same

TABLE 1

FINANCIAL STATEMENTS BEFORE ASSET ACQUISITION

Balance Sheet

Current Assets			$2,300	Current Liabilities:		
				Debt Interest	$ 100	
Fixed Assets				Leases	-	
				Taxes	600	
Owned	$5,000			Other	500	
Depr.	1,000			Total		$1,200
Net		$4,000		Long-term Liabilities:		
				Long-term Debt	$2,000	
Leased	-			Leases	-	
				Total		2,000
Depr.	-			Equity:		
Net		-		Capital Stock	$2,500	
				Surplus	-	
Total			4,000	Retained Earnings	600	
				Total		3,100
Total Assets			$6,300	Total Liabilities & Equity		$6,300

Income Statement

Sales		$15,000
Cost of Goods Sold:		
Leases	$ -	
Depreciation	100	
Other	12,700	
Total		12,800
Net Operating Profit		$ 2,200
Expenses:		
Administrative	$ 750	
Depreciation	150	
Interest	100	
Total		1,000
Net Income		$ 1,200
Taxes		600
Retained Earnings		$ 600

TABLE 2

CASE A--PURCHASED ASSET

Balance Sheet

Current Assets			$3,000	Current Liabilities:			
Fixed Assets				Debt Interest	$ 100		
				Leases	-		
				Taxes	800		
Owned	$7,000			Other	500		
Depr.	1,200			Total		$1,500	
Net		$5,800		Long-term Liabilities:			
				Long-term Debt (5%)	$4,000		
Leased	-			Leases	-		
				Total		4,000	
Depr.	-			Equity:			
Net		-		Capital Stock	$2,500		
				Surplus	-		
Total			5,800	Retained Earnings	800		
				Total		3,300	
Total Assets			$8,800	Total Liabilities & Equity		$8,800	

Income Statement

Sales		$20,000
Cost of Goods Sold:		
Leases	$ -	
Depreciation	300	
Other	17,000	
Total		17,300
Net Operating Profit		$ 2,700
Expenses:		
Administrative	$ 750	
Depreciation	150	
Interest	200	
Total		1,100
Net Income		$ 1,600
Taxes		800
Retained Earnings		$ 800

TABLE 3

CASE B--LEASED ASSET, NOT CAPITALIZED

Balance Sheet

Current Assets			$2,700	Current Liabilities:		
				Debt Interest	$ 100	
Fixed Assets				Leases	-	
				Taxes	800	
Owned	$5,000			Other	500	
Depr.	1,000			Total		$1,400
Net		$4,000		Long-term Liabilities:		
				Long-term Debt (5%)	$2,000	
Leased	-			Leases	-	
				Total		2,000
Depr.	-			Equity:		
Net		-		Capital Stock	$2,500	
				Surplus	-	
Total			4,000	Retained Earnings	800	
				Total		3,300
Total Assets			$6,700	Total Liabilities & Equity		$6,700

Income Statement

Sales		$20,000
Cost of Goods Sold:		
Leases	$ 300	
Depreciation	100	
Other	17,000	
Total		17,400
Net Operating Profit		$ 2,600
Expenses:		
Administrative	$ 750	
Depreciation	150	
Interest	100	
Total		1,000
Net Income		$ 1,600
Taxes		800
Retained Earnings		$ 800

TABLE 4

CASE C--LEASED ASSET, CAPITALIZED

Balance Sheet

Current Assets			$3,140	Current Liabilities:		
				Debt Interest	$ 100	
Fixed Assets				Leases	300	
				Taxes	770	
Owned	$5,000			Other	500	
Depr.	1,000			Total		$1,670
Net		$4,000		Long-term Liabilities:		
				Long-term Debt (5%)	$2,000	
Leased	$2,000			Leases	2,000	
				Total		4,000
Depr.	200			Equity:		
Net		1,800		Capital Stock	$2,500	
				Surplus	-	
Total			5,800	Retained Earnings	770	
				Total		3,270
Total Assets			$8,940	Total Liabilities & Equity		$8,940

Income Statement

Sales		$20,000
Cost of Goods Sold:		
Leases	$ -	
Depreciation	300	
Other	17,000	
Total		17,300
Net Operating Profit		$ 2,700
Expenses:		
Administrative	750	
Depreciation	150	
Interest	260	
Total		1,160
Net Income		$ 1,540
Taxes		770
Retained Earnings		$ 770

method commonly used to retire a loan through equal payments over a specified period of time.

In each Case--A, B, and C--the same overall transaction has taken place. The company has acquired the use of an additional asset and has contracted for a means by which to pay for it. Whether financed by debt or by long-term noncancellable lease, the company still has a long-term liability for which it is responsible. Yet, the accounting treatment presents a very different situation depending upon how the transaction is reflected in the financial statement. Table 5 shows various common financial ratios for each Case. In Cases A and C, the effect is nearly identical; the various financial ratios parallel each other except for the times fixed charges are covered. In Case C, the total lease payment is a fixed charge, but in Case A, only the interest on the loan is a fixed charge. Thus, when a lease is capitalized, the effect is comparable to purchasing the asset through incurring additional debt. However, Case B is grossly different. Leasing without capitalizing has the effect of showing no additional assets being used by the company, and no new liability incurred. In all debt ratios--debt/equity, debt/capital, and debt/total assets--the situation is shown as no different from that existing before the lease was executed. Yet, in measures of return--return on capital or return on total assets--the firm's position is significantly improved. (It was assumed that the new asset

TABLE 5

COMPARATIVE RATIO ANALYSIS

Ratio	Original	Case A	Case B	Case C
Current	1.9	2.0	1.9	1.9
Debt/Equity	.65	1.2	.60	1.2
Debt/Capital	.40	.55	.39	.55
Debt/Total Assets	.31	.45	.30	.45
Return on Capital	12%	11%	15%	11%
Return on Total Assets (ROI)	9.5%	9.1%	12%	8.7%
Times Interest Earned	13	9	17	7
Fixed Asset Turnover	3.5	3.5	5	3.5
Total Asset Turnover	2.4	2.3	3.0	2.2
Fixed Charge Coverage	13	9	5	5

would produce additional net income to the company. If it did not, there would appear to be no reason for acquiring it, unless it was a replacement for an existing asset. In this case, the effect would be to reduce the asset base under Case B, as compared with Case A or C.) In Case B, the additional net income is compared with a constant asset or liability base; thus, an extension of this aspect is that, regardless of the cost of the asset (amount of the lease), if net income were to increase by any amount, however slight, the return measure of the firm would improve. This could hardly be construed as a fair, objective, or realistic evaluation of the financial condition. In the example, sales increase after the asset is procured, and, because of the fixed asset base under Case B, the turnover ratios improve. Under Cases A and C, the asset base is expanded and, as shown in Table 5, turnover has remained constant or decreased slightly. In both the measurement of return on assets or liabilities and the turnover of assets, not capitalizing leases results in excluding from consideration that portion of assets that are leased. The only time the lease appears under Case B is in calculating the times fixed charges are covered.

The hypothetical example has been provided to show the distortion which can occur in financial ratios if leases are not capitalized. If financial statements are to be considered a fair and objective presentation of a firm's

financial condition, leased assets cannot be excluded; capitalizing them on the balance sheet insures that they are considered equally with owned assets, permitting a valid comparison of a firm that leases a significant portion of its assets with one that owns all its assets. Opponents of lease capitalization support the contention that all relevant information can be disclosed in footnotes, and the analyst himself can treat the information as he wishes. If the footnote does contain "all" relevant information, then why not go one step further and show the lease as capitalized? Not doing so could be compared to relegating all debt instruments to the footnote section as well and calling on the user of the statement to calculate the debt position of the firm, as well as the asset valuation. If this were done, the balance sheet would cease to be a summary of financial condition and might as well be discarded. But, if it is to be a summary, then let it be a summary of all information--and this would include leases.

A further aspect of the distortion that can be caused by not capitalizing leases has been presented by A. Tom Nelson in the Journal of Accountancy.[1] In his study he compared eleven companies through calculation of various ratios commonly used in financial analysis. In each company, various leased assets were reported in the footnotes. A

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[1]A. Thomas Nelson, "Capitalized Leases--The Effect on Financial Ratios," Journal of Accountancy, CXVI (July, 1963), 49-58.

second comparison was made using the same ratios, but calculating them after capitalizing them on the balance sheet. His study was limited in scope because of the difficulty of finding statements wherein the footnote information was detailed enough to be able to capitalize the leases without having to guess at or approximate missing data. For each ratio, both before and after capitalizing the leases, the companies were ranked according to the strength of the company or favorableness indicated by that ratio. The results of this study showed that "in 56 per cent of the cases (92 out of 165 observations), there was a spread of two or more places between the firms' positions before and after capitalization. In 7 per cent of the cases (11 out of 165 observations), the spread was six or more places."[1] His results also showed, as might be anticipated, that capitalization changed the ratios most drastically for those companies whose percentage of leased assets to total assets was the highest. His conclusions were that failure to capitalize leases results in what appears to be an improved financial position, whereas, in fact, this is not true, and that the ratios calculated when leases have been capitalized are more meaningful--they measure more accurately what they are attempting to measure--because they account for leases for what they are, a method of financing the acquisition of assets.[2]

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[1] *Ibid.*, p. 56.   [2] *Ibid.*, pp. 52-53, 57.

As shown by the illustration above and the study by Nelson, leasing assets and not capitalizing them results in apparent improvement of the company's financial position. Gant, in discussing the "illusion" of lease financing, observes:

> But what has taken place that would justify this marked improvement [in financial ratios]? The company has exchanged one obligation for another carrying a higher interest rate, and in the process has given away title to its plant and with it any residual value that it may have at the expiration of the lease.[1]

Gant was referring to a sale and lease-back case in which the company sells its plant, pays off its debt financing for the plant, then leases the plant from the new owner. His question and comment are equally applicable to the analogous situation of comparing two firms, one that purchases an asset and one that leases it.

From the standpoint of ratio analysis, capitalizing leases is mandatory if the ratios are to be meaningful when compared with industry averages, with ratios of other firms, with minimum standards used in credit or evaluation analyses, or with past performance of the firm in question. Analysts can capitalize leases from footnote information if it is complete, but the fact that it must be done to permit meaningful analysis lends powerful support to the contention that leases should be capitalized as a normal course of reporting. Failure to do so can only mislead the user of the statements if he does not perform the capitalization calculation, or

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[1] Gant, "Illusion," p. 131.

cannot because insufficient information is disclosed in the footnote.

Matching expense to revenue

A basic concept of accounting is the accrual, or matching, concept. This concept requires that expenses be matched to revenues at the time the revenue is recognized; but those expenses that do not directly relate to specific revenues are charged to the period in which they occur.[1] The question with regard to lease capitalization is whether capitalizing affects the matching of expenses to revenue to a significant degree, and, if so, whether capitalizing or not capitalizing presents the more accurate matching.

In the hypothetical example above, Case B shows that if the lease is not capitalized, the entire lease payment is an expense carried in inventory valuation and is therefore recognized when inventory is sold. If the lease covers an asset not used in inventory production, the lease payment is a period expense. In Case C, where the lease is capitalized, the expense charged to inventory valuation is the depreciation or amortization of the rights of use of the leased asset. The implied interest charges for the lease are charged in the normal manner as an expense of the period in which the interest is earned by the lessor. The amortization of rights could be shown as the difference between the implied interest

[1] Robert N. Anthony, Management Accounting (4th ed.; Homewood, Ill.: Richard D. Irwin, Inc., 1970), p. 64.

charge and the lease payment; however, this would result in an increasing amortization charge each year, which is not consistent with accepted methods of depreciation, straight-line or accelerated.[1] In the example, straight-line amortization was assumed. Table 6 shows the comparative expenses relating to the leased asset in Cases B and C. The greater expense in the early years and lesser expense in the later years, in comparing Case C with Case B, demonstrates that the expense to be matched with a given revenue is different for a capitalized lease than for a lease that is not capitalized. The significance of this difference is dependent upon the variance between the lease payment and the sum of the amortization charge to the asset plus the implied interest charge. In leases written with high rental payments in the early years and lower payments in the later years, this difference can be significant.

The question now becomes one of determining which method is the more "accurate." Revenue accrues as goods are sold; the matching expense is the inventory cost, or cost of goods sold. For the capitalized lease, part of the cost of goods sold is the amortization of the asset, reflecting the decline in service value of the asset. For the noncapitalized lease, this cost is the amount of the rental payment, which probably is related more to such economic aspects as tax considerations and recovery of investment over a period of

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[1] Myers, Reporting of Leases, p. 50.

TABLE 6

REPORTING OF EXPENSES UNDER A LEASE

Income Statement
Year 1

	Case B Not Capitalized	Case C Capitalized
Cost of goods sold:		
Lease	$ 300	
Depreciation		$ 200
Interest		160
Expenses charged to net income	$ 300	$ 360

Note:

In Case B, inventory would be carried at a higher cost.

In Case C, net income in the early years would be lower than in Case B, because of the high interest charge, but in later years as interest charge decreases, net income would be higher in Case C than in Case B.

time shorter than the asset life than to expiration of the value of the asset.[1] This latter type of expense can hardly be judged a more proper matching of revenue and expense than the former. In capitalizing, the interest is a period cost. The interest charge is payment for the method of financing used, having no relation to the value of the asset or to determining expiration of future value. It is properly charged as "an expense of the period during which the money was borrowed."[2] Thus, carrying interest charges in the valuation of inventory is an improper matching of expense to revenue. The rental is the obligation incurred by the lease, and "the timing of the payment of the obligation, be it mortgage or lease, has no necessary bearing on the expiration of the service value of the asset."[3]

In summary, not capitalizing a lease results in charging revenue with an expense determined wholly by the timing of payments to reduce a liability, whereas, in capitalizing the lease, the expense charged to revenue is determined by the decline of service value of the rights to the asset being used, and financing costs, interest, are properly charged as period costs. Capitalizing leases results in proper matching of expenses to revenues; referring to leases in footnotes and

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[1]Graham, "Comment on Opinion No. 5," p. 60.

[2]Anthony, Management Accounting, p. 60.

[3]Graham, "Comment on Opinion No. 5," p. 60.

and charging the entire rental payment as an expense only results in distortion of net income and inventory valuation.

Summary of Factors Favoring Capitalization

To summarize the foregoing case for capitalization of long-term noncancellable leases, the following points are noted:

1. The lease is the equivalent of debt, because the lessee has the same obligations and rights of use of the asset as does an owner.

2. Contrary to Opinion No. 5, it is contended that the obtaining of property rights does create an asset, and that a lease obligation is just as much a liability as is debt from a cash loan. Thus, the only proper accounting treatment is to show the lease on the balance sheet as both an asset and a liability.

3. The lease is not an executory contract with equally unperformed services remaining after its initial transaction has been executed. At that time the lessor's services are complete, and he has no unperformed services remaining.

4. Not capitalizing a lease distorts for comparability any ratio involving fixed assets or debt liability. Capitalizing leases creates a situation for which comparable ratios result, whether a company leases or owns its assets.

5. Expenses are properly matched to revenues only when leases are capitalized, because only then are expenses

determined by expiration of service value and not by the timing of payments to reduce a liability.

The failure to capitalize leases will result in the following financial "errors":

1. An understatement of assets and liabilities.

2. An understatement of amortization and an overstatement of income in the early years, and an overstatement of revenue in the later years of the lease. These result in overstating owners' equity in increasing amounts in the early years, then in lesser amounts in the later years until the end of the lease when no overstatement exists.

3. Overvalued inventories.

4. Distorted ratios.[1]

[1] *Ibid.*, p. 61.

CHAPTER IV

THE CASE AGAINST LEASE CAPITALIZATION

The case against capitalizing leases has many followers, particularly among those in the position of lessor. Chief among the opponents of capitalization is Alvin Zises, president of Bankers Leasing Corporation. Most lessors agree that off-balance-sheet reporting of leases, currently allowed by the AICPA, is a key factor in the tremendous growth in the use of leasing as a method of obtaining assets. They fear that any change in accounting rules requiring more leases to be capitalized will lessen the advantages of leasing, thus causing the leasing industry a significant loss of business. Also fearful of a change in the rules are the companies that currently utilize leases to finance large portions of their assets. Capitalizing these leases would cause their long-term liabilities to expand greatly, a situation which they consider would border on disaster.[1]

Yet, this is not the only argument against capitalization. Other arguments are based on the premises that footnote disclosure is more comprehensive; leases are not the equivalent of debt because of their economic differences;

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[1]Stabler, "Accounting Rules May Be Tightened," p. 34.

footnote disclosure permits more financing to be available to the company; if leases should be capitalized, then so should labor contracts, material contracts, and even future taxes; and, the legal aspect of a lease does not recognize it as an asset and a liability. This chapter will explore each of these areas which support the contention that leases should not be capitalized.

Footnote Disclosure Superior to Capitalization

Zises agrees that the full disclosure of leases is in the general interest of all concerned. His contention is in the manner in which the disclosure is made, believing that current rules, if followed, provide for full disclosure and that lease capitalization is unnecessary as well as undesirable. For existing rules, he cites the S-X Regulations of the Securities and Exchange Commission and *Accounting Research Bulletin No. 43.* Disclosure requirements under Accounting Research Bulletin No. 43 are basically that a firm state "annual rentals . . . [and] some indication of the periods for which they are payable. . . . In the year in which the transaction originates, there should be disclosure of the principal details of any sale-and-lease transaction." S-X Rule 3.18 states that "pertinent facts relative to . . . rental of assets under long-term leases shall be stated briefly." This rule also requires a statement of "amounts

of annual rentals . . . with some indication of the period for which they are payable."[1]

Certainly, leases could be fully disclosed using these guidelines; however, the terms "principal details" and "pertinent facts" are open to wide interpretation. Thus, disclosure could range from a meager offering of facts to spelling out in full the financial terms of the lease. "Some indication of the periods for which they are payable" is also a rather loose definition which could lead to inexactitudes in reporting, while still following the letter of the rule. Too frequently, the letter of the rule is followed rather than its spirit and intent. It is this writer's contention that these rules in no way offer any kind of guarantee that leases will be fully disclosed in footnotes, or even in such a manner that an analyst could apply his method of capitalization to evaluate and compare a company leasing its assets with a company owning its assets. Even Opinion No. 5, issued subsequent to Zises' comments, offers no better defined disclosure requirements. It requires "sufficient information to enable the reader to assess the effect of lease commitments upon the financial position and results of operations, both present and prospective, of the lessee."[2] This information is further defined as:

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[1]Alvin Zises, "Disclosure of Long-Term Leases," Journal of Accountancy, CXI (February, 1961), 37.

[2]Opinion No. 5, para. 16.

> Minimum annual rentals under such leases and the period over which the outlays will be made.
> . . . .
> Rentals for the current year . . . should be disclosed if they differ significantly from the minimum rentals under the leases.[1]

Nelson, in his attempt to evaluate the effect of capitalizing leases, found very few footnote disclosure statements with sufficient information to permit him to perform this capitalization calculation. The problems he encountered were that rentals either were shown for one year only, or covered too broad a time span, or that lease expiration dates were not shown. In no case did he find the original asset cost or implied interest rate of the lease listed.[2]

Zises alludes to the fact that accountants do not follow the rules; thus, enforcement is required to insure that disclosure meets the requirements.[3] However, omission of the problems Nelson enumerated would not appear to violate the minimum required disclosure standards as spelled out in Opinion No. 5; therefore, increased policing to insure that companies abide by the rules would have little effect toward gaining fuller disclosure.

In Accounting Research Study No. 4, Myers listed various types of information which analysts had indicated

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[1] Ibid., para. 16-17.

[2] Nelson, "Effect on Ratios," pp. 50-51.

[3] Zises, "Long-Term Leases," p. 38.

that they desire to know regarding lease commitments. The primary information which all analysts desired was the amount of cash outlay required, year by year. Other items were:

> Current annual rental, fixed and variable--What is the total annual lease obligation at the present level of business?
> Type of property leased--Is it essential to business? Does it have alternative uses?
> Cost of property--If the lease were terminated, what would it cost the company to acquire similar property?
> Options at maturity--Does the lessee have an option to buy at a minimal price?
> Options for early termination--What would it cost the lessee to terminate the lease before maturity?
> Lessee's responsibility for taxes, insurance, maintenance--Is his responsibility that of an owner?
> Default provisions--Are they equivalent to the default provisions found in conventional debt contracts?
> Restrictions against further leasing or debt--What are these restrictions, if any?
> Interest rate implicit in rentals, after providing for lessee's recovery of cost--Is the lessee a good negotiator?[1]

Myers strongly recommended balance-sheet disclosure, but added that until such procedure is required, more disclosure would be needed. He recommended that disclosure include, either in footnotes or in schedules accompanying the financial statement, the following information:

> Type of property leased
> Renewal time and rental
> Cost of property
> Interest rate
> Lessee's obligations
> Unqualified obligation-to-pay clauses.[2]

David Hawkins goes even further by recommending disclosure requirements that include disclosure (1) by categories

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[1] Myers, Reporting of Leases, p. 50.

[2] Ibid., p. 61.

of assets, to show the criticalness of the asset to the company's operation; (2) by geographic location of assets, to indicate whether assets in foreign countries are leased or owned, for better evaluation of risk in the event of nationalization of the country; (3) of the financial condition of major lessors, for better judging the lessor's ability to perform; and (4) of more terms, particularly "hell-and-high water" terms, for better judging of financial risk.[1] These comments certainly are applicable only to very large firms with international operations.

Zises also favors the use of supporting schedules, but the information he recommends for inclusion in the schedule is limited to projected payments over the twenty-year period following the period being reported.[2] These schedules do not include most of the information Myers found to be important to analysts.

A further contention by Zises is that even if leases are capitalized, footnotes are required to provide the full disclosure needed. He argues that if a footnote is needed anyway, why show a capitalized liability figure which would definitely not be the legal liability under any condition?[3] Myers agrees that footnotes would be required in addition to capitalization to provide full disclosure, but argues for

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[1]Hawkins, "Objectives, Not Rules," p. 35.

[2]Zises, "Long-Term Leases," p. 45.

[3]Ibid., p. 41.

capitalization, not from the legal aspect of the amount of the liability, but from the economic aspect of it.[1]

On the basis of the findings by Myers and Nelson, as well as the ideas fostered by Hawkins, Zises' contention that footnote disclosure under existing rules is adequate does not appear valid. However, footnotes could be detailed enough to offer full lease disclosure, if such full disclosure were specifically called for, item by item, in the accounting and securities rules which guide businesses.

Different Economic Effects of Lease and Debt

Zises also argues against capitalizing leases and treating the lease liability as debt because of the following different economic effects of a lease compared with those of a debt:

> 1. Inherently, because of the flexibility inherent in contractual and lease relationships.
> 2. Legally, because of the difference in impact in event of the lessee being in financial difficulty.
> 3. Financially, because leasing may make an extra contribution to earnings as a result of special considerations.
> 4. Tax-wise, because under certain circumstances leasing may reduce the tax burden.
> 5. Operationally, because of economies in operations performed for the lessee by the lessor.[2]

The flexibility he refers to is in regard to the various ways in which leases may be written, particularly considering the rights of termination and associated

[1] Myers, Reporting of Leases, pp. 59-61.

[2] Zises, "Long-Term Leases," p. 38.

penalties that may be involved. A debt is a debt, and it is not subject to cancellation. However, leases, though long-term in nature, may have cancellation rights attached for which the penalty is less--perhaps substantially less--than the remaining sum of lease payments. This point, though true, is not relevant to the lease capitalization controversy, because this controversy centers around the noncancellable lease wherein the obligation of the lessee is absolute. The only exception would be in the event of bankruptcy or reorganization, which brings up his second point, the legal aspect. It is true that the full amount of debt is upheld in such proceedings, whereas the lessor may claim only one year's rent in bankruptcy and three years' rent in reorganization. This argument is counter to the going-concern concept of accounting, as discussed earlier,[1] yet it is not without merit. In reorganization, if the leased asset is essential to the continuance of the business, the new management does have a certain amount of leverage to cause the lessor to alter the terms to make them "more favorable."[2] If the lessor should balk at altering the terms of the lease, he faces gaining only one year's rental as the business ceases to exist. If he alters his terms to allow the lease to continue in being, the rental payments he receives may be less than before, but at least they will continue on into the future. If he has

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[1] Supra, pp. 31-32.

[2] Zises, "Long-Term Leases," p. 39.

no alternate lessee for the property, altering the terms of the lease will obviously be his choice of action. Zises also relates that lenders prefer lending to a firm with a moderate dollar value of leases outstanding rather than to a similar firm, or the same firm, with all debt and no lease financing. In this case, the one that leases may even obtain the loan at a lower interest rate. This is his reason for contending that more financing is available through leasing than through using solely senior debt financing.[1]

The special financial considerations Zises mentions are the federal government's (specifically, the Department of Defense) allowing lease rental costs as expenses in its contracts, but not allowing the cost of debt (or equity) as a justifiable expense; thus, the conclusion is that debt and leases are substantially different.[2]

The fourth item, tax differences, is substantiated on the basis that rental payments for land are tax deductible, yet land cannot be depreciated as a tax deduction. This is true, but for a lessee, the residual value of the land is lost, and it may far outweigh, even in a present-value analysis, the benefit of the tax deduction. However, this does represent a significant difference between owning and leasing. The full rental costs of property other than land are tax deductible, yet in purchasing property through debt

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[1] Ibid., p. 40.

[2] Ibid.

financing, only the interest on the debt is deductible. Not mentioned by Zises is that for owned property, depreciation of the asset is also deductible for tax purposes; therefore, the difference is in comparing the lease payment with the sum of depreciation and interest, rather than interest alone. Only by coincidence would the rental equal interest plus depreciation, so one method will always provide a more favorably timed deduction. Which method is favored will depend on the terms of the lease--level payments or higher payments in earlier years--and the method of depreciation used--straight-line or accelerated. The main point is that there will be a difference, but either leasing or owning could be the more advantageous; leasing does not always have the advantage. Zises warns of adverse legislative action which could follow general capitalizing of leases throughout industry. Relating that the tendency of the law is to follow custom, he is fearful that if accountants were to treat leases as debt by capitalizing them, tax legislation might in turn do the same by not allowing rentals to be tax deductible; thus, any tax advantage of leases might be lost. Zises also foresees that government agencies, which tax total capital, may tax leased assets as well as owned assets.[1] Myers views these potential tax law changes as definite disadvantages to lessees, but sets them aside when debating the capitalization issue on the basis that perhaps there is justification in

[1] Ibid.

shifting the present tax burden away from current taxpayers and onto the lessees, who may now have an unfair tax shield.[1] His evaluation of capitalization is manifested by searching for fair and accurate reporting procedures, rather than basing his stance on whether or not lessees will incur a greater future liability.

The operational factor Zises mentions is related to services provided to lessees by lessors, such as maintenance. In debt financing of assets, the owner must provide such services himself or purchase them from a service organization. In leasing, provision of such services can be a part of the lease. However, this point is irrelevant, since lease capitalization eliminates that portion of the lease and considers maintenance services an operating expense. In capitalizing a lease, future lease payments are discounted at the implied interest rate to form the liability. If services are provided by the lessor, an amount equal to their cost is deducted from the lease payment, and only the net lease payment is discounted to determine the liability. Thus, services provided by leases are not a part of the capitalization question.

More Financing Provided by Leasing

In the lease or buy question, a strongly supported factor favoring leasing is that leasing is a means of providing the firm more total financing than debt alone could

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[1]Myers, Reporting of Leases, p. 54.

provide. This premise is based on off-balance-sheet reporting, not on capitalizing the lease. Thus, a lender would not consider that the lease is debt. The result is purported to be higher debt-carrying capability. In capitalizing a lease, the lease appears identical to debt. Financial ratios used in evaluating a firm are nearly the same if the company leases the asset or owns it through debt incurrence, and the company appears to have more existing debt.

Vancil and Anthony, in 1959, conducted a survey to determine how various members of the financial community regarded leases and whether leasing, as opposed to owning, presented an appreciably different financial situation. A summary of their survey and the results follows.[1] The survey included two groups, financial analysts of financing institutions and corporate treasurers and controllers. The first part of the survey, which dealt solely with the analysts, was to determine whether long-term, noncancellable leases were regarded as debt equivalents. Over 75 per cent of the analysts said that they consider a lease a debt equivalent; however, less than half of these analysts actually used any formal technique to equate leases with debt. Of those using some formal technique, the methods used varied considerably, and only a very few used a capitalization procedure. Their methods involved either summing all future lease payments and

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[1]Richard F. Vancil and Robert N. Anthony, "The Financial Community Looks at Leasing," Harvard Business Review, November-December, 1959, pp. 113-30.

adding some percentage of them to long-term debt, or multiplying the annual rental by some factor and adding the amount to long-term debt. In computing fixed charges, some added the full annual rental, others only a percentage of it, to interest charges to determine coverage of fixed charges. By these procedures, not treating lease obligations as the equivalent of debt, it can easily be seen that leasing could provide more financing than sole reliance on debt financing.

In the corporate survey, the objective was to determine the extent that leases are restricted by covenants in loan agreements. In 50 per cent of the loan covenants that restricted additional debt, restrictions were also placed on long-term leasing. The trend was that as the firm's total long-term debt increased, so did the incidence of restrictive covenants, with long-term debt equaling 15 per cent of total capitalization (long-term debt plus capital and surplus) as the breaking point. Below this 15 per cent, restrictions were not included in loans; but where debt was greater than 15 per cent of capitalization, restrictions were placed on future debt and lease obligations. The primary type of restriction found (two-thirds of the companies) was one that would limit to a given dollar level the total long-term lease payments allowed. A second type of restriction added to debt the discounted value of all future lease payments, and this new debt figure was the one used to verify debt compliance with the loan agreement. Another item discovered in the

survey was that leasing tends to increase for a given firm as its amount of debt increases.

The survey of analysts also attempted to discover whether they viewed leases as new sources of capital, and, if so, how leases ranked among other capital sources. The vast majority agreed that leases were capital sources, and, as such, were debt equivalents--equal to senior corporate debt. Yet, when queried as to why leases commanded a higher rate of interest than debt capital, the primary reason given was the lesser security of a lease--an obvious inconsistency in the analysts' replies.

The last part of the survey asked specifically if the use of long-term leases allowed a firm to obtain an amount of credit greater than if it used only debt financing. In the responses, 65 per cent of the corporate officers and 90 per cent of the analysts replied affirmatively. The main reasons stated to support this conclusion were that financial institutions do not equate leases to debt, that loan agreements do not restrict future leasing, and that more credit would be available because leases do not appear on balance sheets.

The conclusion drawn from the Vancil-Anthony study is that leases, by not being capitalized and not appearing as balance-sheet items, are not judged as direct debt equivalents in the financial community and, in effect, can increase the amount of credit available to the firm. These are the direct results of the survey, but, in reality, how valid

are they? The implication is that, because of the accounting treatment of leases, they are different from debt. Yet, the company has a firm commitment of funds when it engages in leasing, just as it has a firm commitment for repayment of debt. In regard to the increased debt limits obtainable through leasing, Gant questions this point from a soundness principle. His thoughts are that "sound financial management will impose its own limitations on the amount of fixed obligations it is willing to incur, whether in the form of debt or leases, and whether they appear on the balance sheet or not."[1] Although it may be true that leasing can create a situation wherein higher credit limits are obtained, the practicality of exercising such limits may be so remote in financially sound businesses that the matter is strictly academic. Creating such a situation in a firm that is not well grounded financially could be the very thing that would cause the firm eventually to go under--in such cases, the situation wherein the lease can have a lesser position than debt surely would come into play; namely, bankruptcy.

Capitalization of All Future Commitments

As a somewhat backward defense against lease capitalization, the point is made that if leases are to be capitalized, then there are many other commitments which also should be capitalized. Again, Zises comes to the forefront in

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[1]Gant, "Critical Look," p. 312.

suggesting that "capitalization should extend to contruction, subcontracting, pension and retirement, repurchase and all other off-balance-sheet commitments."[1] Also, Cook applies this same reasoning in stating that to require leases to be capitalized would require all contracts involving future services and the associated obligation to be capitalized. He applies this reasoning to such items as purchase contracts for supplies, gas, services, and even sales contracts.[2] Both Cook and Zises interpret the lease as an executory contract, and thus extend the logic of capitalizing leases to all executory contracts. Obviously, this would be highly impractical, because all manner of contingent items would need to be included, such as profit on future sales and future taxes, as well as future rates for utilities.

Gant argues that this approach is unrealistic, because, generally, a company does not enter into a contract for some fixed or minimum quantity of services or materials at a stated price. If there were such a firm commitment, Gant agrees that the obligation would parallel that of a lease.[3] In Accounting Research Study No. 4, Myers' viewpoint is that "improvements must be made as recognized," and that leases have been the subject of a great deal of study, so, the accounting treatment of them should be decided on their individual merit regardless of the interpretation of other

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[1]Zises, "Long-Term Leases," p. 43.

[2]Cook, "Against Capitalizing Leases," p. 157.

[3]Gant, "Illusion," p. 124.

commitments.[1] His idea is to proceed with items one at a time rather than trying to consider and decide on all possible items together at one time. The list is inexhaustive; thus, progress toward a solution or resolution would never be realized. The key element here seems to be whether or not a lease is actually an executory contract. If it is, then the ruling for leases should apply to all executory contracts. If a lease is not executory in nature, then there is justification for treatment of leases separately from these other executory commitments. The official, i.e., APB, viewpoint is that leases are executory in nature as long as they are not, in fact, purchases.[2]

Summary

The case against lease capitalization is structured around five basic factors. The first, the controversy over whether a lease does, in fact, create an asset and a liability, was discussed in Chapter III. Opponents of capitalization currently have the APB on their side, with Opinion No. 5 interpreting creation of assets in the legal definition only; that is, an asset is created only when material equity in the item is obtained--ownership in the legal sense of having title to the item, not the economic sense of having rights of use.

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[1] Myers, Reporting of Leases, p. 7.

[2] Opinion No. 5, para. 7.

The second factor is the theory that footnote disclosure is superior to, or at least as good as, capitalization in defining the obligation under a lease agreement. Certainly, it could not be argued that a footnote could not provide complete disclosure; however, the main point of controversy is whether or not footnotes do provide this totality of information under current disclosure criteria. Thirdly, it is maintained that leases and debt do not have the same economic effect; therefore, their accounting treatment should not necessarily be the same.

The fourth factor is utilized in supporting the case for leasing versus owning, as well as the anti-capitalization movement. This is the contention that leasing, because it is not reported on the balance sheet, permits the company to acquire more credit than if all financing were done solely through debt and equity. The fifth and last factor suggests that further debate and decision on lease capitalization should be held in abeyance until such time as a decision can be reached which would involve all future commitments of the firm; i.e., leases do not stand alone, and all commitment contracts must be judged and ruled upon simultaneously.

CHAPTER V

METHODS OF LEASE CAPITALIZATION AND THE IMPACT OF TAXES

Lease Capitalization

If leases are to be capitalized, there must be established a standard method of doing so. If no standard method is developed, the problem of noncomparability of financial statements among companies will again arise. Under present rules, capitalization methods have two aspects. One is the aspect of the firm itself with regard to capitalizing its own leases, either for internal use only or for use also in its published financial statements. The other aspect is from the viewpoint of the analyst, whether a loan approving officer, an investment analyst dealing in the buying and selling of securities, or the individual investor handling his own portfolio of stocks. From a theoretical standpoint, there should be no difference; one method of capitalization should suffice. However, in practice, there seem to be major differences in the way leases are evaluated, depending in part upon the objectives of the individual performing the evaluation. In the process of analysis, several approaches are taken, all nominally referred to as "capitalization."

It may be the purpose of the analysis that determines the method to be used; or, perhaps, merely the sophistication of the analyst--his familiarity and experience with leases--determines how he will evaluate the effect of leases on the overall capital structure of the firm. Analyses can be divided into two types: the "one shot," or single inquiry, and the multiple, or continuous, inquiry. The analysis accompanying a loan negotiation is likely to be the single inquiry type. The lender has one opportunity to study the firm financially. After the loan agreement has been consummated, further analysis is not warranted unless the lender also provides financial consultation services or the loan is defaulted. The lender makes his basic evaluation of the firm's debt repayment capability in the single analysis, that is, at a point in time prior to loan consummation. Any doubts he may have regarding the future ability of the firm to meet its commitments may be eased through attaching restrictive covenants to the loan which would limit new debt incurrence, the sale of assets, or any other arrangement that would give rise to additional claims against the firm. Analysis for investment purposes can likewise be a single inquiry. This could be the case if one were searching for a long-term investment. Although the progress of the firm would be followed subsequent to the investment, the detailed analysis would be made once, at the beginning. Any subsequent action of the investor would be based on dividend or growth

performance rather than on the financial details of the firm.

The multiple or continuous type of inquiry can be characterized by the firm's own internal analysts, or by investment brokers who would be buying and selling the firm's stock on a continuing basis as the market price fluctuates. The internal analyst would concern himself with the continuous or frequent analysis of the firm's financial situation, because he is in a position, through his recommendations to line management, to affect this aspect of the business. For him, the one-time analysis would be of limited use, for he must be concerned with the dynamic nature of the firm, not a static, singular appraisal. The investment broker is in a similar position, in that he must be concerned with the firm's condition at many points in time. He cannot be effective and use a one-time analysis for all future transactions.

As will be shown below, some methods referred to as capitalization techniques are more static in nature, and more geared to a single analysis. Other methods are more dynamic in their approach and, seemingly, lend themselves better to the utilization of continuous or multiple analyses. Perhaps, it is the singular need that promotes the static techniques, and the continuous need that demands the more dynamic approaches to capitalization.

This chapter will examine the various capitalization techniques in use, with a view to evaluating them comparatively to determine which would be most appropriate for general use as a standard capitalization technique. One element common to all capitalization techniques is the idea that the future rental payments of the lease, or at least some portion of them, are discounted to their present value to determine the extent of the liability. The asset, initially, is identical in value to this liability. The elements that vary are the discount rate, the method of amortizing the asset to offset the liability, and the number of future payments considered. The first techniques that will be examined are those that are considered more dynamic in nature and are more commonly used by the firm itself in analyzing its own financial condition. The second techniques are those that are more static and less rigorous. Also considered will be methods which are not actually capitalization techniques, but means of evaluating the effect of leasing, and more correctly classified as rules of thumb.

The Myers approach

In Accounting Research Study No. 4, Myers concluded that long-term, noncancellable leases should be capitalized, and recommended a method to accomplish capitalization. His method calls for establishing lease liability by discounting to its present value all future lease payments. The discount rate used is the interest rate implied in the lease. The

first determination that must be made is whether or not the terms of the lease include payment by the lessor for services or such expenses as taxes and insurance. Services would include any operating or maintenance services provided by the lessor. These types of expenses are normally recognized as they accrue, and, regardless of whether they are contracted, performed in-house, or purchased through application of a portion of the lease payment, the accounting treatment would be the same.[1] Therefore, from the lease payment must be deducted an amount equivalent to the value of the services and expenses provided by the lessor. By making this deduction, this part of the lease, executory in nature, will not be capitalized and shown as a liability. The portion of the lease payment that is capitalized is only that which represents the right to use the property being leased. Table 7 is an example demonstrating the above. The net lease payment is the figure used in the capitalization of the lease. It has been derived by deducting from the gross lease payment the equivalent cost of all services and expenses paid by the lessor.

The decision as to which leases or what portion of a lease should be capitalized depends on the extent to which the contract or its services have been performed. A right to use the property, to the extent that it is a noncancellable right, represents services performed completely by the lessor

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[1]Myers, Reporting of Leases, p. 38.

TABLE 7

METHOD OF DETERMINING THE PORTION OF RENTAL PAYMENT TO BE CAPITALIZED

The basic terms of the lease are payment of $4,000 per year for twenty years on a noncancellable basis. The value of the property at the end of the lease is estimated to be nil. Lessor pays taxes, insurance, maintenance, and operating expenses.

Gross lease payment		$ 4,000
Estimated cost of lessor-provided services:		
Taxes	$ 200	
Insurance	100	
Maintenance	300	
Operation	200	
Total		800
Net lease payment		$ 3,200
Original cost of property		$40,000

$$\text{Present value factor} = \frac{\text{Present value of property}}{\text{Portion of annual payment capitalized}}$$

$$= \frac{\$40,000}{\$\ 3,200} = 12.5$$

From the present value tables, this represents an implied interest rate of 5 per cent.

at the beginning of the contract. This right and its associated liability in the form of future lease payments are what should be capitalized. Any services to be performed later in the contract, such as paying taxes or providing maintenance or operating services, represent unperformed services, and that portion of the lease representing payment for them should not be capitalized. The basic notion is, as discussed earlier,[1] that services which have been performed (granting the right to use property for some specified time) and the associated future liability incurred (the making of lease payments for a certain future number of years) should be capitalized on the balance sheet.[2]

Once the amount of the lease payment to be capitalized has been determined, $3,200 per year in Table 7, an appropriate discount or interest rate must be chosen. This rate may be known through the negotiation process. If not, but the cost of the asset is known, this implied rate may be computed as shown in Table 7, resulting here in an interest rate of 5 per cent. Myers suggests that if the rate is not known and the cost of the property cannot be closely estimated, an appropriate factor can be selected from:

> (a) the prime rate adjusted for the company's credit worthiness,
> (b) the rate the company is paying for loans recently negotiated, plus ½ to 1 percentage point because of the lease, or

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[1]<u>Supra</u>, p. 36.

[2]Myers, <u>Reporting of Leases</u>, p. 45.

(c) the price on the bond market of similar credit (again raised a point or less because the instrument is a lease rather than conventional debt).[1]

In selecting a rate in this manner, there undoubtedly will be some difference between it and the actual rate used in the lease; however, the error should be small. Table 8 demonstrates the magnitude of the "error" for various assumed rates where the true rate is 5½ per cent. In this example, the cost of the item is $1,000,000. The present value of the lease payment is calculated at various rates, and the difference between the present value figure and $1,000,000 is the error caused by using an incorrect interest rate. It can be seen that where the inaccuracy in interest rate is small, so, too, is the error in present value. As the magnitude of difference in rates increases, or as the life of the lease increases, the error in the present value becomes greater.[2]

In the above case, it was assumed that the asset was leased for its entire useful life, and the present value of the lease at the outset was equal to the cost of the asset. If the lease covered less than useful life, then the present value of the lease would be somewhat less than the cost of the asset. It would be equivalent to the cost of the asset less its present value at the end of the lease. Still, the same procedures would apply in the capitalization calculation.[3]

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[1] Ibid., p. 46.

[2] Ibid.

[3] Ibid., p. 37.

TABLE 8

PRESENT VALUE OF RENTALS AT VARIOUS INTEREST RATES

	Rental	4%	5%	5½ %	6%	7%
5 years	$234,176	$1,042,512	$1,013,861	$1,000,000	$986,436	$960,170
20 years	83,679	1,137,229	1,042,829	1,000,000	959,795	886,469
50 years	59,061	1,268,769	1,078,221	1,000,000	930,918	815,092

Source: John H. Myers, Reporting of Leases in Financial Statements, Accounting Research Study No. 4 (New York: American Institute of Certified Public Accountants, 1962), p. 47.

Once the present value of the lease has been determined, this amount is entered on the balance sheet as the initial value of both the asset and the liability. From this point on, the accounting treatment for a lease parallels that for one asset purchased with borrowed funds. In both cases, the asset value is equal to (or closely approximates) the cost of the asset. The liability is the principal amount of the loan to be repaid. The interest on the loan is shown only as an expense as it accrues. For the loan, presumably a schedule of payments has been established, part of which represents the interest expense for the period calculated on the unpaid loan balance, and the rest of the payment is the amount by which the liability is reduced. The lease is similar. Part of the lease payment represents interest paid to the lessor, and the remainder represents repayment of the principal, which is the reduction of the liability. Table 9 demonstrates a numerical example of these two situations. In each case, the amount by which the liability is reduced in the current year is shown under current liabilities, and the balance of the liability under long-term liabilities. In each case, a single payment is made each year. In the financial statement this payment is divided between expenses (interest, taxes, and maintenance) and the reduction of the liability. This demonstrates the similarity between financial statement presentations for loan and lease financing of an asset when the lease is capitalized.

TABLE 9

FINANCIAL STATEMENT TREATMENT OF A LOAN AND A CAPITALIZED LEASE

Asset purchased with borrowed funds:

Balance Sheet

Fixed assets:		Current liabilities:	
Equipment	$40,000	Loan	$ 1,340
Depreciation	2,000	Long-term liabilities:	
Net	$38,000	Loan (4%, 20 yrs)	$38,660

Income Statement

Depreciation	$ 2,000
Interest	1,600

Loan payment is $2,940. In the first year, interest is $1,600, principal repaid is $1,340.

Asset leased for 20 years at 5 per cent implied interest:

Balance Sheet

Fixed assets:		Current liabilities:	
Equipment (leased)	$40,000	Loan	$ 1,200
Amortization	2,000	Long-term liabilities:	
Net	$38,000	Lease	$38,800

Income Statement

Amortization	$ 2,000
Expenses	800
Interest	2,000

Lease payment is $4,000. Expenses for taxes, maintenance, etc. are $800. In the first year, interest at the implied rate of 5 per cent is $2,000. Repayment of principal to the lessor is $1,200.

The asset created through the lease is treated like any other depreciable asset. Its useful life is determined, presumed to be twenty years in this case, and either a straight-line or accelerated amortization rate is chosen; or, if appropriate, a rate based on utilization can be employed. The main point is that the amortization of the asset proceeds independently of the rate of amortization of the liability. The only times when the two are equal is at the outset and at the end of the lease when each has been reduced to zero. This procedure again equates to the procedure for an asset purchased with borrowed funds.

The rate at which a loan is retired has no bearing on the rate of asset depreciation.[1] In fact, more frequently, the life of the loan would be quite different from the life of the asset. However, for conformity, the two lives are shown to be equal. Using a straight-line depreciation/amortization schedule, in each case the asset would be reduced annually by $2,000. This sum would appear on the income statement as an expense of the period. Thus, total expenses for interest and depreciation/amortization would be $3,600 for the owned asset and $4,000 for the leased asset. Neither of these amounts, of course, agrees with the respective payments of $2,940 and $3,200 ($4,000 minus $800 for other expenses). If the asset were amortized so that the asset and liability were equal in every year, the depreciation

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[1] _Ibid._, pp. 48-49.

or amortization would be of the annuity type, or "decelerated depreciation," which would be completely inconsistent with normal depreciation methods, violating the consistency concept of accounting.[1]

As shown in Chapter III,[2] if the lease is not capitalized, the entire lease payment is shown as an expense, charged to cost of sales, selling expenses, or elsewhere as appropriate. In this case, the interest expense is included in the total lease payment, which results in a greater charge to overhead and less profit before interest deductions. If lease payments are level, the net income is less in the early years and greater in the later years under the capitalized lease than under the noncapitalized lease. If the lease payment schedule calls for higher payments in the early years with reduced payments in later years, the situation is reversed; under the noncapitalized lease the net income is less in the early years and greater in the later years. Table 10 shows a more detailed income statement of the case demonstrated in Table 9, wherein level lease payments cause a lower net income in the early years when the lease is capitalized.

The subject of net income leads to the important area of tax considerations. More explicit discussion of this subject is undertaken at the end of this chapter, but suffice it to say at this point that, under a lease, the entire

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[1] *Ibid.*, p. 50. [2] *Supra*, Tables 1-4, pp. 40-43.

TABLE 10

COMPARATIVE INCOME STATEMENTS REPORTING A LEASE

Lease Not Capitalized			Lease Capitalized		
Sales		$100,000	Sales		$100,000
Cost of Goods Sold:			Cost of Goods Sold:		
Lease rental	$ 4,000		Lease expenses	$ 800	
			Amortization	2,000	
Other	70,000		Other	70,000	
Total		74,000	Total		72,800
Net Operating Profit		$ 26,000	Net Operating Profit		$ 27,200
Selling, Admin. Expense		10,000	Selling, Admin. Expense		10,000
Net Profit		$ 16,000	Net Profit		$ 17,200
Interest		-	Interest		2,000
Net Income		$ 16,000	Net Income		$ 15,200

rental payment is tax deductible. Therefore, if leases are capitalized for the firm's business records, but tax returns are filed on the basis of the rental schedule, it is necessary to show an entry on the business records to account for the difference in tax liability between the two accounting systems. At this point, it is also evident that a rental schedule calling for uneven payments, the early payments being large and the later ones being small, is, in effect, a method of deferring taxes, because of the smaller taxable income occurring in the early years as a result of higher tax-deductible rental payments.

An example of this method, taken from an article by Nelson,[1] is shown as Table 11. In this case, the initial asset and liability figure is established at $5,600,000--the cost of the asset. The lease payments are $420,000 per year for the first twenty years on a noncancellable basis. Renewal options are available at rentals of $196,000 per year for the next five years, $168,000 per year for another five years, and $112,000 per year for two additional five-year periods. This represents the full depreciable life of forty years. Straight-line depreciation is used, resulting in a $140,000 per year charge to depreciation. In each year, the interest charge, based on 5.61 per cent interest on the amount of outstanding liability, plus the reduction of the lease liability, is equal to the rental payment. Column 7 shows

[1]Nelson, "Effect on Ratios," p. 51.

TABLE 11

ACCOUNTING DATA FOR A CAPITALIZED LEASE

Yr. (1)	Deprec. (2)	Interest (3)	Deduct from Lease Liability (4)	Remaining Balance in lease Liability (5)	Rent (6)	Interest Plus Deprec. (7)
0				$5,600,000		
1	$140,000	$314,142	$105,858	5,494,142	$420,000	$454,142
2	140,000	308,204	111,796	5,382,346	420,000	448,204
3	140,000	301,932	118,068	5,264,278	420,000	441,932
4	140,000	295,309	124,691	5,139,587	420,000	435,309
5	140,000	288,314	131,686	5,007,901	420,000	428,314
6	140,000	280,927	139,073	4,868,828	420,000	420,927
7	140,000	273,125	146,875	4,721,953	420,000	413,125
8	140,000	264,886	155,114	4,566,839	420,000	404,886
9	140,000	256,185	163,815	4,403,024	420,000	396,185
10	140,000	246,995	173,005	4,230,019	420,000	386,995
11	140,000	237,290	182,710	4,047,309	420,000	377,290
12	140,000	227,041	192,959	3,854,350	420,000	167,041
13	140,000	216,217	203,783	3,650,567	420,000	356,217
14	140,000	204,785	215,215	3,435,352	420,000	344,785
15	140,000	192,712	227,288	3,208,064	420,000	332,712
16	140,000	179,962	240,038	2,968,026	420,000	319,962
17	140,000	166,497	253,503	2,714,523	420,000	306,497
18	140,000	152,276	267,724	2,446,799	420,000	292,276
19	140,000	137,257	282,743	2,164,056	420,000	277,257
20	140,000	121,397	298,603	1,865,453	420,000	261,397
21	140,000	104,646	91,354	1,774,099	196,000	244,646
22	140,000	99,521	96,479	1,677,620	196,000	239,521
23	140,000	94,109	101,891	1,575,729	196,000	234,109
24	140,000	88,393	107,607	1,468,122	196,000	228,393
25	140,000	82,357	113,643	1,354,479	196,000	222,357
26	140,000	75,982	92,038	1,262,441	168,000	215,982
27	140,000	70,819	97,181	1,165,260	168,000	210,819
28	140,000	65,367	102,633	1,062,627	168,000	205,367
29	140,000	59,610	108,390	954,237	168,000	199,530
30	140,000	53,530	114,470	839,767	168,000	193,530
31	140,000	47,108	64,892	774,875	112,000	187,108
32	140,000	43,468	68,532	706,343	112,000	183,468
33	140,000	39,624	72,376	633,967	112,000	179,624
34	140,000	35,563	76,437	557,530	112,000	175,563
35	140,000	31,276	80,724	476,806	112,000	171,276
36	140,000	26,747	85,253	391,553	112,000	166,747
37	140,000	21,965	90,035	301,518	112,000	161,965
38	140,000	16,914	95,086	206,432	112,000	156,914
39	140,000	11,580	100,420	106,012	112,000	151,580
40	140,000	5,947	106,053	-41	112,000	145,947

Source: A. Thomas Nelson, "Capitalized Leases--The Effect on Financial Ratios," Journal of Accountancy, CXVI (July, 1963), 51.

the sum of the interest and depreciation charges each year. This combined charge is shown for the purpose of comparison with the rental charge each year. By this comparison, it can be seen that the deductions on the income statement under capitalization are greater in the first six years than if only the rental payments were deducted to arrive at net income. The opposite trend occurs through the twentieth year. In the twenty-first year, the rental is reduced substantially, and from that point on, again the depreciation plus interest expense is greater than the rental payment. From this analysis, it is clearly evident that the decision whether or not to capitalize a lease has a substantial effect on reported net income and, concomitantly, on the timing of the tax liability.

The Shillinglaw approach

Gordon Shillinglaw has proposed a lease capitalization technique which is similar to Myers' approach. The initial value of the asset and liability is determined in the same manner, as is the amortization of the liability. In establishing the initial asset value, Shillinglaw proposes that the purchase price, or cost, of the asset be reduced by the present value of the right of ownership, or residual value, of the property at the end of the lease. Thus, where there is a residual value of the property, the rights to this value represent the only rights that the lessee does not

acquire, but that the owner of the property does acquire.[1] Therefore, to equate leasing with owning, this difference is recognized by reducing the purchase cost of the asset by the present value of the rights of ownership not obtained through the lease, i.e., the rights to the residual value. If the estimate of residual value is accurate, then, presumably, the lessee can purchase these terminal rights of ownership for this amount at the end of the lease. If he does so, his situation is identical to that of the individual who purchases the property at the outset rather than leasing it; and both, eventually, will have paid the same purchase price. The only difference would be that the lessee probably paid a higher interest rate by financing through a lease than did the owner who financed his purchase through his normal source of capital.

The point of difference between Myers' approach and Shillinglaw's is the method used to amortize the asset representing the rights obtained by the lease. Shillinglaw argues against using a straight-line or accelerated method, showing preference for amortizing the asset by the same method that the liability is amortized. He supports this position by stating that what is being amortized "is not the market value of a bundle of ownership rights but instead the approximate cost of user rights. . . . The cost of the rights

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[1]Gordon Shillinglaw, "Leasing and Financial Statements," <u>Accounting Review</u>, XXXIII (October, 1958), 584.

is represented at any point in time by the capitalized value of the payments that must be made to secure them."[1] He further supports his position by stating that the value of the rights to the lessee is greater than their cost; thus, cost and not value is what must be amortized.[2] This writer agrees that the value of any asset to the owner or user must be greater than its cost. If it is not, then there is no logical reason for having obtained the asset in the first place. However, to continue Shillinglaw's thought, it would appear to apply to all assets regardless of whether they are leased or not, and any utilization of normal depreciation methods would be meaningless. Depreciation rates would always be tied to the rate of expiration of the liability incurred to obtain the asset. Throughout accounting, cost is used as the measure of value in accordance with the cost concept.[3] Paul Grady, in Accounting Research Study No. 7, states that depreciation is the means "to distribute the cost or other basic value of tangible capital assets . . . over the estimated useful life of the unit. . . . It is a process of allocation, not of valuation."[4] He also states that leases

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[1] Ibid., pp. 586-87.

[2] Ibid.

[3] Anthony, Management Accounting, p. 29.

[4] Paul Grady, Inventory of Generally Accepted Accounting Principles for Business Enterprises, Accounting Research Study No. 7 (New York: American Institute of Certified Public Accountants, 1965), p. 126.

are intangible assets, the cost of which "should be amortized by systematic charges in the income statement over the period benefitted, as in the case of other assets having a limited period of usefulness."[1] None of the foregoing would indicate that the expiration of value of an asset should have any relation to the method used to finance it, but that it should relate to some rational distribution over the life of the asset. The asset life of a lease and the life of the liability are necessarily the same. The life of an asset purchased through a loan and the life of the liability are usually different. It does not appear that, solely because the two lives are identical in length, the method of allocating the cost of the asset should materially change.

Shillinglaw offers a final reason supporting the amortizing of the asset and the liability by the same method. He does not believe that reported net income should be altered because a lease is capitalized. His contention is that the total charge to income should always be equal to the lease payment regardless of how lease accounting is handled. As an alternative to the annuity or constant yield method of amortizing the asset and the liability, he offers a straight-line amortization method wherein the amortization and interest expense each remain constant throughout the life of the lease. This method results in a variable interest rate, one that is lower than the true interest rate

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[1] _Ibid._, p. 262.

in the early years and higher in the later years. He rejects this alternative on the basis that it is not consistent with the manner in which the asset and liability are derived initially, namely, by using the constant yield method.[1]

The Vancil-Anthony study

Thus far, two approaches to capitalization have been presented. These methods are more closely associated with the lessee himself, because to use them requires knowledge of the complete terms of the lease. This information is not usually available in toto in footnote reporting of leases, as evidenced by the frustrations Nelson experienced in his attempt to capitalize leases from information reported in footnotes.[2] The second stage of the Vancil-Anthony survey, discussed in Chapter IV, was an attempt to learn how analysts capitalize lease commitments in studying the financial condition of firms. The results of their survey represent a second grouping of methods of lease capitalization--methods utilized by those appraising not their own, but someone else's financial statements.

The question asked by the survey was to evaluate the impact of a leasing situation described in a case example. The basic details were that the lease was for twelve years, was noncancellable, and had an annual cost of $3,000,000.

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[1]Shillinglaw, "Leasing and Financial Statements," p. 587.

[2]Nelson, "Effect on Ratios," pp. 51-52.

Vancil and Anthony established that the equivalent debt should be in the range of $25 million to $28 million. These figures were derived from discounting the twelve years of payments at both 6 per cent and 5 per cent to obtain the present value of the lease. The outside limits of the range represent the two different percentage factors used. This discounting method was judged by Vancil and Anthony as the most appropriate means by which to equate the lease to debt for inclusion in the financial analysis.[1] Also, it is evident that they believed regarding the lease as a debt equivalent was the most appropriate analytic treatment of the lease.

The results of the survey showed some greatly divergent responses. Using the $25-$28 million range as a benchmark, of the 41 respondents, 11 were within this range, 14 considered the equivalent amount of debt greater than $28 million, and 16 considered it less than $25 million.[2] Half of the respondents were insurance companies and half were commercial banks. Of the 16 respondents reporting a liability of less than $25 million, 10 reported that they did not capitalize leases or consider them debt equivalents. The others regarded only a portion of the future rentals as the equivalent debt. One method considered only the total rentals due for the next five years; another considered one-half of the future rentals due; others used some fixed

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[1]Vancil and Anthony, "Financial Community," pp. 116-19.

[2]*Ibid.*, p. 120.

multiplier times the annual rental charge.[1] The basis of these multipliers apparently was the manner of defining "capitalizing." Gant refers to sophisticated approaches to lease evaluation as capitalizing the annual lease rental payment at an arbitrary rate from 6 per cent to 8 per cent. He defines capitalizing at 6 per cent as meaning the annual rental representing 6 per cent of the "unamortized investment in leased property." Thus, if 6 per cent were the assumed rate, the debt equivalent would be 16.7 (1/.06) times the annual rental. An 8 per cent rate would give a multiplier of 12.5 (1/.08), and a 5 per cent rate would give a multiplier of 20 (1/.05). He admits that these rates do tend to overstate the true lease liability by implying a much longer remaining life of the lease than actually exists. For example, if the lease would return 5 per cent to the lessor, the use of 16.7 as the multiplier (6 per cent capitalization rate) would indicate thirty-six years remaining life of the lease.[2]

Some of the replies to the survey used the 6 per cent capitalization rate under Gant's definition, and some used it to mean discounting the future payments at a 6 per cent discount rate. The results of these two definitions of "capitalizing at a 6 per cent rate" are substantially different. The first definition results in a liability of $50.7 million (16.7 times $3 million), and the second a liability of

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[1] Ibid., pp. 119-20.

[2] Gant, "Illusion," p. 139.

$25.2 million ($3 million times 8.384, the present value factor of an annual sum for twelve years at 6 per cent).

Of those analysts reporting a liability greater than $28 million, most used multipliers of 10, 16 2/3, or 20, which would represent "capitalization rates" of 10 per cent, 6 per cent, and 5 per cent, respectively; and two used merely the product of the annual rental and the number of years remaining in the lease.

The only analysts using some consideration of the time value of money were those in the benchmark range. All used discount rates within the 5 per cent to 6 per cent range. All other methods avoided consideration of the time value of money, certainly a tragic flaw according to the theory of Joel Dean, a foremost authority in the field of finance.[1]

As another measure of the effect of leasing in financial analysis, the respondents to the survey were asked to state the amount which they would add to interest for computing fixed charge coverage. In this area, 31 of the 41 respondents would add the full $3 million annual rental charge. The others would add either a fraction, such as one-third or one-half of the annual charge, or nothing.[2] The survey points out that among those queried there is a much greater consistency in the evaluation of leases in terms of fixed charges

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[1] Joel Dean, "Measuring the Productivity of Capital," Harvard Business Review, January-February, 1954, p. 130.

[2] Vancil and Anthony, "Financial Community," p. 120.

than in terms of the amount of equivalent debt represented by a lease.

The conclusion is that not only do the methods used by analysts to capitalize leases vary, but that the varied results, in terms of equivalent debt added to balance sheets can have a significant impact on the granting of additional credit to a company. The fact that in examining the same firm one analyst will regard a lease as adding no liability, and another analyst will consider it an additional liability in excess of $50 million, certainly points to the desirability of having a consistent approach to measuring the effect of long-term leasing agreements. As Gant points out, it is questionable whether or not those firms using leases as a means of financing realize the impact on additional granting of credit that such leasing can hold, or that it can present a much more severe, and thus costly, outlook than if the assets were owned.[1] If nothing else, capitalizing leases under a standard method would eliminate any unfair or inconsistent comparison of one firm with another, as each seeks capital at the most favorable rates of interest.

Conclusion

It is this writer's opinion that the approach to capitalization of leases presented by Myers is the superior method for equating leasing to debt, because (1) it recognizes

[1] Gant, "Illusion," p. 139.

the time value of money, and (2) it depreciates the asset in relation to the expiration of its service life independently of the time sequence of the payments for its financing. This procedure is also fully in accord with the description in Opinion No. 5 of how a lease is to be capitalized. Opinion No. 5 states:

> The property and the obligation should be stated in the balance sheet at an appropriate discounted amount of future payments under the lease agreement. . . . The method of amortizing the amount of the asset to income should be appropriate to the nature and use of the asset and should be chosen without reference to the period over which the related obligation is discharged.[1]

The Effect of Leasing on Income Taxes

Two primary tax advantages are claimed for leasing over owning, and both are based on the tax ruling that rental payments are operating expenses and are therefore tax deductible. The first claimed advantage is that a tax saving is effected, because leases can be written to require high payments in the early years with smaller payments in later years, which results in a faster writer-off than can be made under depreciation of an owned asset. Also, many leases have a basic term which is shorter than the depreciable life of the asset allowed under tax regulations. Again, the effect is an earlier write-off of the value of the asset for tax purposes. The second claimed advantage is that if the leased property includes land, writing off

[1] Opinion No. 5, para. 15.

the rental payments as a tax deduction has the effect of allowing land to be depreciated for tax purposes, a situation not allowable under ownership.[1]

The first advantage was based primarily on comparing a lease with an owned asset depreciated under the straight-line method. The advent, in 1954, of accelerated depreciation methods being allowed for income tax purposes, as well as the 1962 changes allowing shorter depreciable lives for various assets, has greatly negated the tax advantage of leasing over owning.[2] There is no actual tax savings; there is only a shift in the timing of tax payments which results from writing off the asset earlier. If a quicker write-off could be effected, a benefit would derive from the time value of money, because tax payments would be deferred to a later year.

The writing-off of land values is not necessarily advantageous. True, the investment in leased land is partially recovered by claiming a tax deduction, but, in the process, the land itself becomes the property of the lessor at the end of the lease. So, although the lessee, through tax benefits, does not pay for the full value of the land, he has use of it only during the period of the lease and loses all rights to it at the end of the lease. If the lessee had any residual rights of ownership or could purchase the property for less than the market value at the end of the lease, the Internal

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[1]Gant, "Illusion," pp. 126-27.

[2]James H. McLean, "Economic and Accounting Aspects of Lease Financing," <u>Financial Executive</u>, XXXI (December, 1963), p. 18.

Revenue Service (IRS) would not regard the transaction as a lease, but as a purchase, thus eliminating the ability to deduct the cost of the land for tax purposes.[1]

Vancil points out that the lessor who owns the property must depreciate it according to the life criteria stated in the IRS depreciation guidelines. From a tax standpoint, if the lessor offers a rental schedule favorable to the lessee, he will create a more disadvantageous tax situation for himself, because he will receive more income earlier and pay more tax sooner. Vancil suggests that certainly the lessor will include in the rental schedule compensation for the tax burden he assumes by allowing the lessee to gain a tax advantage.[2] The result would be one more cost factor to be added to the true cost of leasing.

If there are tax advantages to leasing over owning, the lessee must be most careful to insure that the IRS will consider the agreement a lease and not a purchase. Although each lease agreement is judged by the IRS on its own merits, the following have been proposed as general guidelines:

1. Be sure that no portion of the lease rentals are specifically applicable to an equity to be acquired by the lessee.
2. Have no provision in the contract that the lessee is to obtain title upon payment of a stated amount of rentals.
3. Provide for rental payments over the entire period of the lease; in particular, do not provide for

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[1]*Ibid.*, p. 19.

[2]Richard F. Vancil, "Lease or Borrow: New Method of Analysis," *Harvard Business Review*, September-October, 1961, p. 127.

high rental payments during the first years of the lease and only nominal payments in later years.

4. Do not provide rental payments in excess of the fair rental value of the property.

5. Provide for a fair and realistic option price if the contract includes an option to purchase. A price based on the appraised value of the property, to be determined at the time the option may be exercised, cannot be questioned.

6. Do not designate any part of the periodic payment as interest.[1]

The following guidance for the lessee has been proposed by a tax specialist to insure that IRS will not regard his lease as a purchase:

1. If possible, a lease with an option to purchase should be avoided.

2. If a lease with an option to purchase cannot be avoided, the rentals should be fair.

3. No portion of the rents should be applied against the purchase price of the property.

4. The option price should be the actual value of the property at the end of the lease.

5. The lessee and the lessor should treat the transaction on their books as a lease transaction; that is, the lessee should claim a deduction for rent paid, and the lessor should pick up the income as rent and claim depreciation on the property.[2]

In a survey conducted by George Marrah in 1968, he found that most of the sixty manufacturers participating acknowledged that leasing offered no tax advantage or, usually, no tax-shield advantage over owning.[3] Vancil, in his Harvard Business Review article on how to negotiate a

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[1]McLean, "Economic Aspects," p. 19.

[2]Roy Soll, "Tax and Business Considerations in Leasing Property," Taxes, March, 1964, p. 164.

[3]George L. Marrah, "To Lease or Not to Lease?" Financial Executive, XXXVI (October, 1968), 100.

lease, has cautioned that the lessee must be careful to insure that payments are scheduled in an accelerated way so as not to incur a disadvantage over owning, where accelerated depreciation could be used for tax purposes.[1]

Summary

The tax considerations of leasing are of primary importance. The way in which a lease is written must be carefully reviewed to assure, from a tax standpoint, that it is at least as advantageous as owning. Because of accelerated depreciation methods for taxation, being able to deduct the full lease payment no longer insures a tax advantage over owning. The lessee must assure that the terms of the lease will cause the IRS to judge it as such, in order that any tax benefit may be realized.

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[1]Richard F. Vancil, "Lease or Borrow: Steps in Negotiation," Harvard Business Review, November-December, 1961, p. 156.

CHAPTER VI

SUMMARY AND CONCLUSIONS

Summary

This study is presented as a compilation of information surrounding the question whether there is a need for the Accounting Principles Board (APB) to provide additional clarification and guidance in its published rules regarding lease accounting. Two aspects of lease accounting are involved in this question. One concerns lease disclosure requirements and what information needs to be disclosed, and the other concerns the method of disclosure to be used.

The current rules governing the reporting requirements of the lessee are contained in Opinion No. 5. From the research reported in Chapter III, it is obvious that the disclosure requirements are not as stringent or as specific as they need to be. Disclosure should allow the analyst to capitalize the leases reported if he so desires; yet, reporting of all relevant information is not now required. The result is that those analysts who regard a lease as a debt are not able to treat it accurately as such without additional information. The effect, from the standpoint of the lessee, may be, unhappily, conservative treatment by an analyst, which would reflect the lease as more debt than it

actually is. In such an instance, the action of the analyst would be reflected by a less favorable endorsement of the firm than it deserves. The cost to the firm could be a higher interest rate on the loan it is about to secure.

The question of the disclosure method to be used strikes directly at the question of capitalization. But whether or not capitalization should be the method used for reporting all noncancellable leases, the more pressing problem is the interpretation of Opinion No. 5 as currently written. Hawkins summarizes the situation as follows:

> Some lessees are accounting for similar transactions in different ways. These problems appear to result from 1) the inability or unwillingness of some managements and their public accountants to use judgement in implementing the over-all objectives of Opinion No. 5 in "dual purpose payment" situations, such as installment sales disguised as leases; . . . (2) the misreading of certain illustrative examples given in Opinion No. 5 as the sole conditions requiring lease capitalization; 3) confusion as to how many of these illustrative conditions must be present to require capitalization; and, 4) the inventiveness of certain lawyers, businessmen, and accountants in designing lease transactions that violate the spirit of Opinion No. 5, but are so artfully drawn up that the agreements circumvent the rules for capitalization set forth in the Opinion.[1]

Thus, the basic research question, "Should the present rules of the APB be altered to provide more specific and more stringent guidance in accounting for leases?" can only be answered in the affirmative. The rules need to be more specific in defining the types of leases which should be capitalized, and more stringent in the disclosure requirements. If one accepts Myers' philosophy of what constitutes

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[1]Hawkins, "Objectives, Not Rules," p. 31.

creation of an asset, then these rules must also be more stringent as to which leases should be capitalized..

In evaluating Opinion No. 7, the same criteria apply to lessors as to lessees under Opinion No. 5. This issue was not developed as a controversy, because the problems of lessors' accounting have received very little attention, compared to that paid lessees. The basic issue is one of symmetry. Certainly, it is illogical for both lessee and lessor to treat the same leased asset as an owned asset and depreciate it. Likewise, it is just as illogical for neither to consider himself the "owner." Yet, these inconsistencies can and do occur regularly under the existing rules.[1] The solution lies in reviewing both opinions simultaneously, so that they will provide complementary, not asymmetrical, guidance. When the lessor shows the asset as owned and depreciates it, the lease should be of the operating type, and the lessee should not capitalize it. If the lessor uses the "finance" method, considering the asset "sold" and establishing a receivable in the amount of rentals due, the lessee should be obligated to capitalize the lease.[2] This is not to be construed as an arbitrary choice of the lessor, but a choice based on the terms, and thus the intent, of the lease. Whether the creation of an asset turns on gaining material equity in the property leased, or on obtaining

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[1]Stabler, "Accounting Rules May Be Tightened," p. 34.

[2]Myers, Reporting of Leases, p. 9.

property rights, the end result should be the same: symmetrical lessee and lessor reporting of leases. As indicated in Chapter III, leases primarily involved in the controversy and the "free" interpretation are the financial leases, those leases which are long-term and noncancellable. Leases which are for terms shorter than the life of the property and are subject to cancellation on short notice pose few accounting problems, because both lessor and lessee consider them what they really are--operating leases--and inconsistencies do not arise.

Capitalization of leases is the main consideration of this study. From the standpoint of accounting, there appears to be no question that financial leases should be capitalized. In fair and objective accounting, these leases can only be regarded as debt equivalents, because they contain the same characteristics. This fact can be succinctly demonstrated by comparing the rights of property use obtained by the lessee, and the liability incurred, with those of an owner of identical property financed through debt. No arguments against capitalization can withstand the strength of this single argument for capitalization when the purpose is objective accounting. Primarily, those arguments against capitalization are aimed at promoting leasing as a benefit to the lessee, without objective consideration of accounting concepts and principles. In the final analysis, capitalization presents the firm's financial position in a more factual manner.

> Arguments against lease capitalization cannot be permitted to stand. The same arguments could be made for not reporting any other kind of liability. The question is one of disclosure or partial concealment. Lease capitalization does not create liabilities where none have existed before; it merely adds them up and places them in a prominent place. And liabilities should be kept out in the open for inspection, not ignored or buried in footnotes.[1]

This writer concurs with Myers' criterion for determination of asset creation, favoring the economic rather than the legal issues as the determining factors. In this belief, the tenets of Opinion No. 5, based on material equity rather than attainment of property rights, are rejected as invalid criteria for lease accounting. Also favored by this writer, for the reasons stated in Chapter V, is Myers' method for capitalization. The primary reason for capitalization is that the lease is equivalent to debt. Only Myers' approach treats lease accounting as identical to debt; all other methods treat leases as somewhat different from debt. If the lease and debt are identical, then the treatment should be identical.

The main implication derived from the tax aspects of leasing is that a lease can be written so as to provide a tax benefit. However, to gain this position, the lease will border on becoming a sale. As a result, consultation with a tax specialist is necessary to assure that the IRS will concur that the instrument does represent a lease and not

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[1]Shillinglaw, "Leasing and Financial Statements," p. 590.

a purchase. An unfavorable IRS decision could deprive the lessee of the very thing that made the lease economically superior to a purchase--the tax benefit of more favorably timed tax liabilities.

Capitalization Ramifications

In the event the two APB committees now in session do provide the impetus for requiring that all, or at least more, financial leases be capitalized, the effect on American business concerns will be significant. Zises, in 1961, wrote in fear that lease capitalization, if required, would place in default a vast number of term debt indentures which contained restrictive covenants regarding additional term debt. He foresaw adverse repercussions falling to all manner of society, "shareholders, creditors and investors."[1] His fears were not unfounded. As well as absolute limitations on further debt incurrence, maintenance of various minimum or maximum ratios also appear as covenants to debt instruments. As shown in Chapter III, capitalization of leases can significantly affect financial ratios, and the effect is a more adverse relationship. Yet, because the effect of an action is adverse does not constitute its being wrong. Again returning to the philosophy of Shillinglaw:

> If these ratios are used in regulatory proceedings, the standard ratios might be altered to allow for the effects of lease capitalization. On the other hand, if the standard ratios have some definite meaning either

[1] Zises, "Long-Term Leases," pp. 43-44.

> in logic or in law, then there is even more reason for lease capitalization in order to bring reported ratios more closely into accord with actual facts. We must return once more to the fact that a liability exists and financial statements that fail to disclose this liability are incomplete and may be misleading.[1]

If the ability to maintain leases in an off-balance-sheet manner is a primary factor in a firm's choosing to lease rather than own, then surely the leasing industry itself would suffer if more leases were required to be capitalized. Yet, it must be reiterated that only long-term noncancellable leases are involved. All other leasing arrangements would be unaffected by financial lease capitalization, and it would not doom financial leasing to nonexistence. In 1971, Stabler alluded to businessmen's having the same fears of capitalization that Zises warned of a decade earlier. Yet, he indicated that the thinking of many accountants and analysts was on the positive side, foreseeing "more comprehensive, consistent reports than currently are available" as a result of forced capitalization.[2]

Conclusion

It is the accounting profession that has the duty and responsibility to insure that generally accepted accounting principles are formulated in a manner which causes the financial position of a firm to be reported fairly in its financial statements. Opinions of the APB are a vital

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[1]Shillinglaw, "Leasing and Financial Statements," p. 591.

[2]Stabler, "Accounting Rules May Be Tightened," p. 34.

element in the makeup of these principles, and there is no room for ambiguous reporting criteria which allow interpretation to be so broad as to permit the same item to be reported in opposite ways, depending solely on the desires of the firm reporting, or to allow form to overrule substance. The need for revising _Opinion No. 5_ and _Opinion No. 7_ is unmistakably clear.

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Thesis 134469
R853 Rugless
A study of the advantages and disadvantages of lease capitalization.